

BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF WASHINGTON

In the Matter of the Application)
regarding the Conversion and)
Acquisition of Control of)
Premera Blue Cross and its)
Affiliates) Docket No. G02-45
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)

Adjudicative Hearing

May 11, 2004

Day 6

(Pages 1226 - 1452)

Tumwater, Washington

Taken Before:

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INDEX

WITNESSES

PAGE NO.

JOHN STEEL

Direct by Mr. Mitchell	1255
Cross by Mr. Hamje	1279
Cross by Mr. Madden	1320
Cross by Ms. McCullough	1334
Redirect by Mr. Mitchell	1337

JONATHAN KOPLOVITZ

Direct by Ms. deLeon	1352
Cross by Mr. Mitchell	1384
Cross by Ms. McCullough	1423
Redirect by Ms. deLeon	1437
Recross by Mr. Mitchell	1440
Recross by Ms. McCullough	1444
Exam by Mr. Kreidler	1446
Further Redirect by Mr. Mitchell	1450

EXHIBIT INDEX

NO.	DESCRIPTION	OFFERED	ADMITTED
P-30	Washington State Population Survey	1348	-
P-31	Spokane Journal of Business, Book of Lists, "Health-Care Plans," dated 12/11/2003	1348	-
P-32	HealthLeaders Report, Washington Health Plan Data, PPO Enrollment, dated 7/11/2003	1348	-
P-33	Spokane Journal of Business: "No Easing on Health Premiums," dated 11/13/2003	1348	-
P-34	Factiva: "Health plan premiums climb," dated 2/25/1999	1348	-
P-74	Premera Blue Cross Press Release: "GAO Report: Technology Investments by Premera Blue Cross, Save Millions, Improve Service and Quality of Care"	(Withdrawn on pg. 1247)	
P-84	Pre-Filed Direct Testimony of John Steel, filed 3/31/2004	1257	1258
P-85	Mr. Steel's Resume	1257	1258
P-86	Steel Report, dated November 10, 2003	1257	1258
P-87	Steel Supplemental Report, dated March 5, 2004	1257	1258
P-88	Pre-Filed Responsive Testimony of John Steel, 4/15/2004	1257	1258
P-89	Excerpts from 3/10/2004 Deposition of Patrick Cantilo; Excerpts from 3/22/2004 Deposition of Patrick Cantilo	1257	1258
P-101	Deposition Transcript of Martin Alderson Smith, dated 11/24/2003	1254	1254

EXHIBIT INDEX

(Continued)

NO.	DESCRIPTION	OFFERED	ADMITTED
P-102	Deposition Transcript of Martin Alderson Smith, dated 11/25/2003	1254	1254
P-103	Deposition Transcript of Martin Alderson Smith, dated 3/9/2004	1254	1254
P-104	Memorandum from LeBoeuf, Lamb, Greene & MacRae re Comments to the Proposed OIC Issues List	1254	1254
P-105	E-mail from Nicholas Lardo to John Hamje with attached Blackstone Issues List	1254	1254
P-106	E-mail correspondence re Issues List	1254	1254
P-110	Deposition Transcript of Patrick Cantilo, dated 12/1/2003	1254	1254
P-111	Deposition Transcript of Patrick Cantilo, dated 12/2/2003	1254	1254
P-112	Deposition Transcript of Patrick Cantilo, dated 3/10/2004	1254	1254
P-113	Deposition Transcript of Patrick Cantilo, dated 3/22/2004	1254	1254
P-114	E-mail correspondence between Patrick Cantilo and Andrew Taktajian re Admission Pro Hac Vice	1254	1254
P-115	Memorandum from Pierre Riou to Patrick Cantilo re Laws Applicable to Premera Blue Cross Proposed Conversion, dated 8/19/2002	1254	1254
P-116	Memorandum from Andrew Taktajian to Patrick Cantilo re Charitable Foundation and Organizations, dated 11/11/2002	1254	1254

EXHIBIT INDEX

(Continued)

NO.	DESCRIPTION	OFFERED	ADMITTED
P-117	Abbott v. Blue Cross and Blue Shield of Texas, Inc., et al	1254	1254
P-118	E-mail Correspondence between Patrick Cantilo and Andrew Taktajian re Response to Rusty's lack of use of the unsold shares during the sell-down period	1254	1254
P-119	E-mail Correspondence between Patrick Cantilo and Andrew Taktajian re Charitable Trust	1254	1254
P-122	E-mail Correspondence between Patrick Cantilo and Andrew Taktajian re Premera-Ipo stock value dilution	1254	1254
P-123	E-mail Correspondence between Patrick Cantilo and Rusty Fallis re Opinions	1254	1254
P-124	E-mail Correspondence re Draft Opinion	1254	1254
P-125	E-mail Correspondence between Patrick Cantilo and Andrew Taktajian, John Hamje, Jim Odiorne and Melanie deLeon re Draft of Brief re Privilege Issues	1254	1254
P-128	Memorandum from Andrew Taktajian to Patrick Cantilo re Regulatory Authority over the Blue Cross Blue Shield Association, dated 10/17/2003	1254	1254
P-129	Series of E-mails	1254	1254
P-131	Exhibit 7: Comments on and Corrections to Cantilo & Bennett's October 3, 2003 Letter and Draft Report	1254	1254

EXHIBIT INDEX

(Continued)

	NO.	DESCRIPTION	OFFERED	ADMITTED
1				
2				
3	P-132	E-mail Correspondence between	1254	1254
4		Andrew Taktajian and Patrick		
5		Cantilo re comments to Premera's		
6		"errors" document		
7	P-133	E-mail Correspondence between	1254	1254
8		Patrick Cantilo and Andrew		
9		Taktajian re Premera Draft Report		
10		New Deadline		
11	P-134	Series of E-mails and Memoranda	1254	1254
12		to/from Rusty Fallis		
13	P-135	Series of E-mails re Premera's	1254	1254
14		"petition for judicial review"		
15	P-136	E-mail Correspondence re	1254	1254
16		Foundation Articles of		
17		Incorporation and Bylaws		
18	P-137	E-mail Correspondence between	1254	1254
19		Rusty Fallis and Patrick Cantilo		
20		re Premera conversion transaction		
21		documents		
22	P-138	E-mail Correspondence between	1254	1254
23		Andrew Taktajian and Rusty Fallis		
24		re Tax Call		
25	P-139	E-mail Correspondence between	1254	1254
		Andrew Taktajian and Patrick		
		Cantilo re Charitable Trust		
	P-140	E-mail Correspondence between	1254	1254
		Rusty Fallis and Patrick Cantilo		
		re Opinions and related matters		
	P-141	E-mail correspondence between	1254	1254
		Rusty Fallis and Patrick Cantilo		
		re Premera-IPO stock value dilution		

EXHIBIT INDEX

(Continued)

NO.	DESCRIPTION	OFFERED	ADMITTED
P-142	E-mail Correspondence between Rusty Fallis and Patrick Cantilo re Foundation shareholder voting rights restrictions	1254	1254
P-143	Memorandum from Patrick Cantilo to Rusty Fallis re IPO Issues, dated 2/22/2003	1254	1254
P-144	E-mail and Memorandum re Critique of Blackstone's Draft Report	1254	1254
P-145	Memorandum from Patrick Cantilo to Rusty Fallis re Premera Blue Cross Conversion Transaction Documents	1254	1254
P-146	E-mail Correspondence between Patrick Cantilo and Andrew Taktajian re 60 Day Order Issued	1254	1254
P-147	E-mail Correspondence between Andrew Taktajian and Nicholas Lardo re Blackstone Report	1254	1254
P-148	E-mail Correspondence between Andrew Taktajian and John Ellis re Dr. Leffler/AG's Office	1254	1254
P-149	E-mail Correspondence between Patrick Cantilo and Rusty Fallis re Premera Conversion Transaction Documents	1254	-
P-150	E-mail Correspondence between Andrew Taktajian and Patrick Cantilo re Premera Update	1254	-
P-158	Excerpts from Edward Gold Deposition Transcript, dated 11/26/2003	1254	1254

EXHIBIT INDEX

(Continued)

NO.	DESCRIPTION	OFFERED	ADMITTED
P-159	Excerpts from Sandra Hunt Deposition Transcript, dated 11/25/2003	1254	1254
P-160	Excerpts from Sandra Hunt Deposition Transcript, dated 3/11/2004	1254	1254
P-173	Deposition Transcript of Jonathan Koplovitz, dated 11/20/2003	1254	1254
P-174	Deposition Transcript of Jonathan Koplovitz, dated 11/21/2003	1254	1254
P-175	Deposition Transcript of Jonathan Koplovitz, dated 3/8/2004	1254	1254
P-176	Deposition Transcript of Keith Leffler, dated 11/26/2003	1254	1254
P-177	Deposition Transcript of Keith Leffler, dated 12/5/2003	1254	1254
P-186	Excerpts from 12/1/2003 Deposition of Donald Nemerov	1254	1254
P-187	Excerpts from 12/2/2003 Deposition of Donald Nemerov	1254	1254
P-188	Excerpts from 11/25/2003 Deposition of Martin Staehlin	1254	1254
P-194	Deposition Transcript of Aaron Katz, dated 12/5/2003	1254	1254
P-195	Deposition Transcript of Aaron Katz, dated 12/12/2003	1254	1254

EXHIBIT INDEX

(Continued)

	NO.	DESCRIPTION	OFFERED	ADMITTED
1				
2				
3	P-196	Deposition Transcript of	1254	1254
4		Aaron Katz, dated 4/8/2004		
5				
6	P-201	Excerpts from 12/1/2003	1254	1254
7		Deposition of Steven Larsen		
8	S-1	Koplovitz's curriculum vitae	1355	1355
9	S-2	Blackstone's Report (Report	1355	1355
10		on Valuation and Fairness)		
11				
12	S-3	Blackstone's Supplemental	1355	1355
13		Report (Review of G-10 and		
14		Equity Incentive Plan)		
15	S-4	Blackstone's Supplemental	1355	1355
16		Report (Updated Report on		
17		Valuation and Fairness)		
18	S-5	Blackstone's Report on	1355	1355
19		Allocation between WA and AK		
20	S-6	Blackstone's Updated Report	1355	1355
21		on Allocation between WA and AK		
22	S-49	Koplovitz's Pre-Filed Direct	1355	1355
23		Testimony		
24	S-50	Koplovitz's Pre-Filed	1355	1355
25		Responsive Testimony		
	S-86	Fax from Mitchell to Hamje re	1286	1286
		Comments/Corrections regarding		
		10-3-03 draft OIC consultant		
		reports with Exhibits 1 & 7		
	I-161	Allocation of Premera Stock	1254	1255
		Value, dated February 23, 2004		
		Reden & Anders, Ltd.		
	I-162	Supplemental Report on Proposed	1254	1255
		Conversion of Premera Blue Cross,		
		dated February 27, 2004, Signal		
		Hill Capital, cover page & 59-61		

1
2
3
4
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P R O C E E D I N G S

9:00 a.m.

JUDGE FINKLE: Ready to proceed?

MR. KELLY: Yes. This is a preliminary matter this morning. On behalf of Premera, we would ask the Special Master to enter instructions requiring the OIC Staff to have Mr. Odiorne testify on Friday as to what his recommendations and conclusions are so that we would have time, along with the intervenors, over the weekend to evaluate those conclusions and to comment and cross-examine on it. We certainly generally understood that Mr. Odiorne - that the OIC Staff was planning to have him testify at the end of the hearing. We indicated in our brief concern about that. He is a fact witness. He should have submitted his factual statement as to what he was going to testify to like everyone else. He submitted a one-page statement. And that statement basically said, I'll tell you later what I'm going to say."

Without waiving any objection to that procedure, if he is permitted to testify, as I expect he will be, we think it is important certainly for Premera to be able to evaluate what he has to say. This is apparently crucial testimony. We are hopeful that it will be very favorable to us. But on the off chance that it's not, we would need to be able to

1 evaluate it and respond to it. I would expect that the
2 intervenors would also need to have that time if they wanted
3 to have that input.

4 Equally important, the Commissioner certainly deserves
5 to have the statements from Mr. Odiorne, but also to have a
6 thorough review of those statements and response to them if
7 appropriate, from Premera. So for those reasons, we think
8 that a fair way to resolve this issue is not to wait to the
9 very end of the hearing and try and do something on the fly
10 but rather to have him testify - and we would recommend at
11 the end of Friday, which should certainly be at the end of
12 their case, which is the normal time under your order which
13 was contemplated for presentation of evidence - your order
14 reflects that should first be Premera, then the OIC and then
15 the Intervenors - so that we have adequate time to respond.

16 JUDGE FINKLE: Let me hear first from the
17 Intervenors.

18 MS. HAMBURGER: Your Honor, we have no objection
19 to the procedure proposed by the OIC Staff to have
20 Mr. Odiorne speak at the very conclusion of the proceeding.
21 We had interpreted that to mean that it would be akin to a
22 closing argument and that it would be after the presentation
23 of our information so that could also be taken into account
24 in the staff's recommendation to the insurance Commissioner.

25 MR. HAMJE: Your Honor, we first discussed -

1 mentioned the possibility that Mr. Odiorne would go ahead and
2 speak at the very end of the - or at the close of the
3 evidence in this case back when he submitted his pre-filed
4 direct testimony and we've since talked about it again in our
5 prehearing memorandum.

6 As I discussed with you and the Commissioner at the
7 opening statement of OIC Staff, this is an unusual case
8 because in a normal instance, we would have already - the
9 staff would have already developed the recommendation and
10 submitted it at the very beginning of the hearing. But
11 because of the unusual nature of how this hearing has - how
12 this process has proceeded, that has not been possible. The
13 staff has not been able to obtain a full understanding of
14 what all of the issues are, what all of the facts are, only -
15 we've only been able to take a look at items basically under
16 a magnifying glass, you know, just looking at words here and
17 there. It's really the situation where you have the trees
18 getting in the way of being able to look at the forest.

19 Normally in a situation like this, we would have been
20 able to figure that out in informal discussions prior to any
21 formal proceeding. That - because of that, we have not
22 formulated a recommendation and I cannot speak myself for
23 Mr. Odiorne. But it was his intention as communicated to us
24 as well as the intention that we communicated to you, the
25 Commissioner and the other parties, that it was necessary for

1 him to hear not only Premera's case, but also hear the
2 consultants on the record as well as the Intervenor's case.
3 And if we are asked to put him on prior to the Intervenor's
4 case, it is very possible that he would be unable to
5 communicate with you or the Commissioner his recommendation.
6 He may not have it formulated at that point in time. I just
7 don't know and I can't predict that at this point in time.
8 That is really the issue here is whether or not he'd be able
9 to communicate something that's meaningful if he were to get
10 up on the stand earlier.

11 Now, what we had suggested as a means of trying to deal
12 with what we anticipated to be some objections along this
13 line from Premera, which by the way is the first time that I
14 understand that it's been raised, is that he would at the end
15 of evidence . . . Wouldn't be like an ordinary closing
16 statement, which would normally be argued by attorneys and
17 there would not be any cross-examination permitted. It was
18 our intention and Mr. Odiorne's intention to put him on the
19 witness stand, swear him in, let him go ahead and proceed
20 with his recommendation, and then to the extent that the
21 parties wanted to ask him questions about it, they certainly
22 were welcome to do so.

23 For that reason, we believe that we should proceed
24 according to what we've requested and that you should deny
25 Premera's request for these instructions.

1 JUDGE FINKLE: Are you suggesting that his only -
2 Mr. Odiorne's only statement or testimony would be at that
3 time, though he has apparently been listed as a fact witness?

4 MR. HAMJE: Yes. We listed him only as a fact
5 witness because we felt like that we had to give Premera
6 notice of that fact. In fact, if I recall correctly, also in
7 our list of witnesses, we did mention that this was the
8 intention that we had for Mr. Odiorne, to present his
9 recommendation at the end of the close of the evidence as
10 well. So there was additional notice to Premera at that
11 time.

12 JUDGE FINKLE: Right. But you would not be asking
13 to have Mr. Odiorne testify twice, once during OIC's
14 presentation of evidence and the second time after the
15 conclusion of other evidence.

16 MR. HAMJE: That's correct. The only purpose of
17 his testimony is just to make the recommendation and then
18 discuss it, discuss the reasons for it.

19 JUDGE FINKLE: Okay.

20 MR. KELLY: If I could just respond. This is
21 really the law according to the OIC Staff. There's
22 absolutely no procedural precedent for this. Starting with
23 his self-assertion that, "Well, this isn't like another case
24 and we couldn't tell you about it at the beginning, before
25 the hearing." He then leaps to the conclusion that,

1 "Therefore, we can't tell you about what Mr. Odiorne's
2 position is going to be until the very end of the hearing."
3 Doesn't follow whatsoever.

4 I find it incredible that Mr. Hamje is telling you that
5 he doesn't know what his client, Mr. Odiorne, thinks about
6 this case that for 2 years and \$18 million they have done an
7 investigation.

8 This is not just a procedural nicety. It's a real
9 issue. Presumably he could either say, "We approve it" -
10 then I think our cross would be pretty short - or, "We reject
11 it" - and then we're going to find out why - or, "We approve
12 it with conditions." And we need to have a chance to be able
13 to talk with the Commissioner - or question him so that the
14 Commissioner can hear fully whether there is any merit to the
15 conditions that Mr. Odiorne has apparently been keeping
16 solely to himself for these many years. It's just - there's
17 no excuse to have basically the equivalent of an October
18 surprise at the end of this hearing. It's not appropriate
19 for such an important matter for the people of our state.

20 The additional issue raised is the need to get
21 additional input from the Intervenors. Now, Mr. Odiorne and
22 his attorneys have already seen the briefs of the
23 Intervenors. They've seen the pre-filed testimony of the
24 Intervenors. There is absolutely no reason to think that
25 Mr. Odiorne does not have more than enough information at

1 this time, or certainly by the end of his own case, to be
2 able to say to us what his position is. And I think again
3 that the idea of, "Well, we have to wait until all the
4 Intervenor testimony is in is really just a further way of
5 continuing to hide the ball here. And that's precisely what
6 is happening, and there's no excuse for it.

7 Frankly he should put his testimony on at the beginning
8 of his case. After all, his case is all pre-filed testimony
9 already. But we're not even asking for that. We're just
10 saying that certainly by Friday, at which time they should
11 have all of their testimony in, and it should have been
12 crossed, that Mr. Odiorne should have to come forward and
13 speak and say whether he's in favor of conversion, whether
14 he's opposed to it or whether he's in favor of it with
15 conditions. And all we're asking is that we then have, over
16 the weekend, an opportunity to prepare a cross-examination of
17 Mr. Odiorne like any other witness.

18 All the other witnesses, each side has had weeks of
19 pre-filed testimony so that they can prepare informative
20 cross so that they can assist the Commissioner in evaluating
21 the real merits of the testimony. Mr. Odiorne is the only
22 exception. He has said, "I'm not going to tell you what I'm
23 going to say until the very end." Well, he will then have
24 had two weeks of a hearing and then he should be able to say
25 after that and two years of investigation almost and

1 \$18 million of due diligence what he thinks. And then we
2 simply are asking for an opportunity to do the
3 cross-examination on Monday so that the Commissioner will
4 then have a full and thorough understanding of the merits or
5 lack of merits of Mr. Odiorne's position.

6 Finally I would say if - he should be required to do
7 that. And then if there is anything that comes out
8 exclusively from the cross-examination or examination of the
9 Intervenor witnesses, he can then supplement his opinions or
10 revise them, provided that it is strictly within the confines
11 of what he learned from the Intervenors and if that is not
12 abused. Simply another way to avoid the issue.

13 So we ask that you simply order that Mr. Odiorne, by
14 the end of Friday or the end of their case, testify as to
15 what his position is, that we have over the weekend to
16 evaluate it and cross-examine on Monday. Thank you.

17 MR. HAMJE: Your Honor, I just want to add
18 something. Premera is making an assumption here too that may
19 not be appropriate. But it's - I do want to point out that
20 it is possible that the OIC Staff will not complete its case
21 by Friday so the weekend may not be available to Premera if
22 you granted this order. It will have to be at the end of the
23 case, whenever that might be. But just with that observa-
24 tion, I - that's all I have.

25 JUDGE FINKLE: Mr. Kelly, last word. Your motion.

1 MR. KELLY: Yes. This is really a due process
2 issue. We should not be subjected to a surprise witness or
3 position at the very end of this long and arduous journey,
4 nor should the Commissioner nor frankly should the public.
5 And I think that states my position. Thank you.

6 JUDGE FINKLE: I'm assuming I heard you out.

7 MS. HAMBURGER: Yes.

8 JUDGE FINKLE: I won't keep you hanging on this
9 but I'm going to take it under advisement for a bit.

10 Other procedural issues before we begin the hearing
11 this morning?

12 MR. MITCHELL: Yes, your Honor. We have some
13 issues about exhibits. The first issue relates to Exhibit
14 P-74. You will recall that Exhibit P-74 was introduced
15 during the testimony of Mr. Smit. It was a press release
16 describing a GAO report on information technology.
17 Intervenors' counsel objected that the press release was not
18 best evidence and proposed that we either substitute or
19 augment Exhibit P-74 with the full GAO report. We have the
20 full GAO report here this morning. The references to Premera
21 begin on page 96. And I guess in keeping with the
22 instructions that we understand we had been given, to
23 supplement the record, we would ask that we be given leave to
24 augment Exhibit P-74 with the full GAO report to which the
25 press release relates.

1 MS. HAMBURGER: Your Honor, I have no objection to
2 the substitution of the GAO report for the press release.
3 But again, my objection as to the use of a press release to
4 explain the underlying information, you know, put Premera's
5 spin on the facts of the GAO report. And so I would ask that
6 the report stand in for the press release.

7 JUDGE FINKLE: Any - anything from OIC?

8 MS. deLEON: No.

9 MR. MITCHELL: I think, your Honor, unless there
10 be any suggestion that by combining the press release with
11 the report, that we are in some way coloring the latter, we
12 would then offer the GAO report as Exhibit P-219, which is
13 the next exhibit in order. I think that the Court has
14 already admitted Exhibit P-74. And if there's an issue
15 associated with changing the exhibit after it's been
16 admitted, we would offer this up fresh as Exhibit P-219.

17 JUDGE FINKLE: Did you have something to add?

18 MR. MITCHELL: There was one other thought. And
19 that was that there was cross-examination done with respect
20 to the press release so it is important that it be a part of
21 the record. We do not withdraw the press release, which has
22 already been admitted.

23 JUDGE FINKLE: Was there cross on the report
24 itself? Remind me. There's certainly cross related to the
25 subject matter, but I'm not so certain - perhaps I can be

1 persuaded otherwise - that there was cross about the press
2 release.

3 MR. MITCHELL: Actually because that was the
4 matter that was before the Court - before the hearing officer
5 and the parties at that time, I believe Ms. deLeon did ask
6 questions about it. My notes reflect that and I'm sure the
7 transcript would as well.

8 JUDGE FINKLE: I believe it's appropriate that
9 only the report itself be admitted into evidence just to keep
10 the record clear. What's the new number that you suggested?

11 MR. MITCHELL: P-219.

12 JUDGE FINKLE: P-219 is admitted. P-74 at this
13 time is withdrawn from evidence. But if you can demonstrate
14 to me and I think it's a pretty small matter. But if you
15 want to take the time to demonstrate to me that there was
16 cross specifically on that issue, I'll certainly take a look
17 at the transcript.

18 MR. MITCHELL: Sure. We'd be happy to do that.
19 The other matter that we wanted to bring before you this
20 morning, Judge Finkle - and I apologize that time has
21 progressed to the normal hearing time - was the admission of
22 exhibits that we would propose to offer as part of our case
23 but relate to deposition testimony given by experts in this
24 case, principally for the OIC Staff but also in two instances
25 for the Intervenors. And let me tell you two things about

1 that.

2 First, with respect to the - those instances in which
3 we submitted full transcripts, we have, as you know, gone
4 through and actually made specific designations of pages and
5 lines of testimony and have provided those, with one
6 exception, to the parties and to the hearing officer. The
7 other thing I would say is that there can be, of course, no
8 question about authenticity or reliability of the testimony.

9 Would you like to hear the exhibit numbers that we
10 propose to offer at this time?

11 JUDGE FINKLE: Well, let's talk about it in
12 principle and then we can get to the detail.

13 MR. MITCHELL: Sure.

14 MS. deLEON: Yes, your Honor. The OIC Staff
15 objects to the use of the depositions as exhibits in this
16 proceeding. We believe that it's an impermissible use of
17 depositions. These were discovery depositions taken in
18 accordance with the APA, 34.05.446 sub 3. And in that
19 instance, the Civil Rules do apply, specifically Civil Rule
20 26 through 36. These were not perpetuation depositions. We
21 were not given notice that these were perpetuation
22 depositions.

23 Premera has about 13 hours left, as I recall, of their
24 time. And they've given us the highlighted portions of the
25 depositions. The experts of the depositions are here live.

1 They can provide live testimony. So Premera could just ask
2 the questions that they've highlighted out of the
3 depositions. We believe that the depositions shouldn't be
4 used in this instance, for three reasons: One, that we don't
5 believe that it's permissible under the Civil Rules to use
6 the depositions in this way. Second, it puts a burden on the
7 Commissioner to have to read these excerpts of the
8 depositions at a later time in lieu of hearing live testimony
9 as the action occurs in this courtroom. And number three, it
10 takes the testimony out of the earshot of the public. The
11 Commissioner said at the beginning of this proceeding that he
12 wanted this matter to be as public as possible. And
13 providing these depositions as exhibits takes that testimony
14 out of the arena of this proceeding and makes it a private
15 read-only type of testimony. And we believe that that should
16 not happen.

17 Again, I believe that Premera has about 13 hours left
18 in their - on their time clock. And if they want to ask the
19 experts these questions, they will be here and available for
20 any questions that they so desire.

21 MS. HAMBURGER: Your Honor, the Intervenors also
22 oppose the use of the depositions in this manner. Every
23 piece of evidence - with the exception of the few documents
24 identified by the Commissioner in his order, every piece of
25 evidence that's been submitted so far in this proceeding has

1 come in through a live witness. Premera is able to use parts
2 of the depositions to impeach their witnesses or, as
3 Ms. deLeon identified, to ask the same questions in the
4 depositions.

5 By trying to submit this evidence . . . When you
6 submit evidence through a witness, then we have the
7 opportunity to redirect the witness, to question the alleged
8 relevance of the information or to point out other
9 information that would help support our witness's testimony.
10 You can redirect it and you can rebut the inferences when you
11 have the opportunity to do it live. It's unfair to use the
12 depositions in this way as a substitute for live impeachment.
13 It allows Premera to, at the end of the hearing, when we're
14 doing our post-hearing briefs, to basically dump what it
15 considers to be contradictory testimony into the hearing
16 briefs. As you know, there's no opportunity for rebuttal on
17 the hearing briefs. So we would all have to then try to
18 anticipate and guess how Premera is going to use these, you
19 know, literally volumes of deposition excerpts in their
20 post-hearing brief. It's going to make the post-hearing
21 briefs enormous, lengthy, and trying to use them to
22 substitute for what really should be the testing of evidence
23 at live testimony.

24 Additionally, there's no special circumstances here for
25 Premera. We're all living under this time clock. In fact,

1 it was Premera that suggested the time clock in the first
2 instance. We've - should not be . . . The time clock should
3 not be - Premera should not be permitted to use the time
4 clock system to its advantage.

5 This unusual use of depositions, if we had known way
6 back when, in November and December, when we started doing
7 the depositions, that this is how they were going to be used,
8 we would have all conducted them differently. So it's unfair
9 at this late date to use the testimony in this fashion.

10 MR. MITCHELL: I did not understand, your Honor,
11 that we were going to here reargue the matter that was heard
12 before you before the hearing began. And I thought I
13 understood your ruling at that time. I find it remarkable
14 and appalling that the OIC Staff wants to withhold from the
15 Commissioner, the decision maker in this case, the sworn
16 testimony of its own consultants.

17 I think it's remarkable as well that under the
18 standards for admission and exclusion of evidence in this
19 case as set forth in the staff's own brief, that there's no
20 ground whatever for exclusion of this evidence. It has every
21 indication of reliability. It was taken under oath in the
22 presence of counsel with the opportunity to correct.

23 I would note as well that the standards under the
24 Holding Company Act that govern this proceeding provide that
25 at the hearing, which we are now in, the person filing the

1 statement and any person whose significant interest is
2 determined by the Commissioner to be affected may present
3 evidence, examine and cross-examine witnesses and offer oral
4 and written arguments and, in connection therewith, may
5 conduct discovery. That's what happened in this case. We
6 have the sworn evidence. We have made every effort to
7 excerpt from it that - those portions which are relevant.

8 The process which your prior order contemplated and
9 which we have contemplated as well is if there is any
10 counterdesignation of the evidence that's contemplated by the
11 parties, that would happen subsequently. We have no
12 objection to that, of course, at all.

13 If there's any concern that this testimony is in any
14 way out of the public eye, we would not object to its being
15 posted. After all, the parties actually went through the
16 effort of designating AEO portions of the testimony already,
17 and we would be happy to provide redacted versions for
18 posting if that was something that the OIC Staff really
19 wanted. Let me come back to the standards of evidence that
20 apply in this proceeding. Under the APA, this is
21 quintessentially evidence upon which a reasonable person
22 might rely.

23 I would note in addition that the record in this case
24 includes thousands of postcards submitted by the Intervenors
25 as to which one would be hard-pressed to say there is any

1 indication of reliability or even authenticity. To exclude
2 sworn testimony by the consultants, who spent millions upon
3 millions of dollars in this case, from this record we think
4 would be a denial of due process and clear error.

5 JUDGE FINKLE: The excerpts will be admitted. I
6 believe that they are evidence upon which a reasonable
7 decision maker might rely. The burden on the Commissioner is
8 unfortunate. I'll nonetheless assume that he wishes to have
9 before him all evidence proffered by any party that is
10 evidence upon which a reasonable decision maker might rely.
11 The testimony should not be taken to be out of the earshot of
12 the public more than other items admitted into evidence are.
13 Not all of the evidence in this case has been presented
14 orally. We have the pre-filed direct and responsive
15 testimony, the public comments and many other matters that
16 have not been presented live at the hearing. The - of
17 course, the counterdesignations as desired by either the OIC
18 Staff or the Intervenors will be made a part of the record as
19 well. I would say that by the close of evidence, those
20 designations must be made.

21 MR. MITCHELL: Let me mention something that
22 counsel from Intervenors raised yesterday, which was whether
23 we would be offering counter counterdesignations. I assured
24 them at that time and I assure you here that we will not do
25 anything like that.

1 May I identify then the exhibits in question?

2 JUDGE FINKLE: Yes.

3 MR. MITCHELL: They are P-101 through P-106
4 inclusive. P-110 through P-119 inclusive. P-122 through
5 P-125 inclusive. P-128 and P-129. P-131 through P-150
6 inclusive. P-158 through P-160 inclusive. P-173 through
7 P-177 inclusive. P-186 through P-188 inclusive. P-194
8 through P-196 inclusive, and P-201.

9 JUDGE FINKLE: Those are admitted. And I would
10 suggest that, just to keep it as simple as possible, we
11 consider that this ruling contemplates the admission of the
12 counter-designations as well. If there's any issue related
13 to these, I'll hear it. But just let's complete the record
14 now. Any other preliminary issues?

15 MS. McCULLOUGH: Alaska Intervenors would like to
16 at this time admit Exhibit I-161 and I-162.

17 Judge Finkle. These are simply the Alaska reports
18 that you previously deemed that we could introduce.

19 JUDGE FINKLE: Any objection?

20 MR. MITCHELL: Your Honor, assuming that the
21 exhibits are the same ones upon which you have passed in
22 making rulings upon the admissibility of the Alaska reports,
23 that is that they are restricted to the allocation items that
24 you addressed in your prior ruling, we would have no
25 objection. In fact, I think you already ruled on this.

1 JUDGE FINKLE: Right. I haven't specifically
2 admitted them. They are admitted. Just so we're not
3 delaying, if Premera can take a closer look and I'll
4 reconsider. But they appear to me to be exactly what you -
5 what you said.

6 MS. McCULLOUGH: They are.

7 JUDGE FINKLE: Those are admitted. Anything else
8 preliminary?

9 MR. MITCHELL: I'm sorry. Our next witness is
10 John Steel, also our final witness.

11
12 JOHN STEEL, having been first duly sworn by the
Judge, testified as follows:

13
14 JUDGE FINKLE: Please sit down.

15
16 DIRECT EXAMINATION

17
18 BY MR. MITCHELL:

19 Q Mr. Steel, would you please state your name and spell your
20 last name for the record.

21 A Yes. John M. Steel, S-t-e-e-l.

22 Q Please state your position and your business address,
23 Mr. Steel.

24 A I'm a lawyer in private practice of law. I'm a partner with
25 the law firm Gray Cary Ware and Freidenrich, 700 Fifth

1 Avenue, Seattle, Washington.

2 Q I think it's 701 Fifth Avenue.

3 A 701 Fifth Avenue. Sorry.

4 Q How did you come to be involved in this proceeding,
5 Mr. Steel?

6 A I was asked by Premera to render an independent opinion on
7 various matters of corporate law and practice.

8 Q Can you summarize your qualifications and experience with
9 Washington corporate law, please.

10 A Yes. I've practiced law in Seattle, Washington, for 34 years
11 almost. And nearly all of that has had a focus almost
12 exclusively on corporate and securities law matters with a
13 wide variety of corporations, both for-profit and
14 not-for-profit corporations.

15 Q Mr. Steel, your pre-filed direct testimony has been served
16 and filed in this proceeding. Do you adopt that testimony?

17 A I do.

18 Q And your resume, hearing Exhibit P-85, is attached to your
19 pre-filed direct testimony; is that correct?

20 A Yes.

21 Q Mr. Steel, your pre-filed responsive testimony has been
22 served and filed in this proceeding as well. Do you adopt
23 that testimony?

24 A I do.

25 Q Does your responsive testimony refer to attached excerpts

1 from the deposition testimony of Patrick Cantilo?

2 A Yes, it does.

3 Q Have you also submitted expert reports in this proceeding,
4 Mr. Steel?

5 A Yes.

6 Q How many?

7 A Two of them, one in September of last year and a supplemental
8 report in February I believe it was.

9 Q Do these reports contain your analysis of certain issues
10 raised in this proceeding?

11 A Yes.

12 Q Do you adopt those reports as part of your testimony here?

13 A I do.

14 MR. MITCHELL: Your Honor, Mr. Steel's pre-filed
15 direct testimony has been marked as hearing Exhibit P-84.
16 His resume is P-85. His reports are P-86 and P-87. And his
17 responsive testimony is P-88. Finally, the exhibit to his
18 pre-filed responsive testimony is P-89. With Mr. Steel's
19 adoption of his pre-filed testimony and of his reports,
20 Premera now moves to admit Exhibits P-84 through P-89
21 inclusive.

22 MR. HAMJE: Excuse me. What is P-88?

23 MR. MITCHELL: P-88 I believe is Mr. Steel's
24 responsive testimony.

25 MR. HAMJE: And what's P-89?

1 MR. MITCHELL: The exhibit to his responsive
2 testimony.

3 MR. HAMJE: Okay. No objection.

4 MR. MADDEN: No objection.

5 JUDGE FINKLE: Admitted.

6 Q (BY MR. MITCHELL) Mr. Steel, as an expert on matters of
7 Washington corporate law, do you believe that the conversion
8 process proposed in Premera's Amended Form A and the
9 corporate decision making processes that underlay the
10 proposed conversion comply with Washington law?

11 A Yes, I do.

12 Q As a prologue to your testimony on some of the issues in this
13 case, Mr. Steel, can you explain to the Commissioner, please,
14 how the notion of a charitable trust has become a topic of
15 discussion here?

16 A Yes. The - I believe the issue arises primarily out of the
17 OIC consultants' reports which indulge the assumption that
18 Premera's assets are subject to charitable trust restrictions
19 and that they build a number of other legal arguments on top
20 of that assumption.

21 Q Mr. Steel, why would the Premera board of directors propose
22 to establish charitable foundations to receive 100 percent of
23 the stock of New Premera if the board was not obligated to do
24 so?

25 A Well, having made a decision that Premera needed more capital

1 and having made the decision that the most optimal way of
2 accessing that capital was to go to the public markets,
3 somehow they needed to convert Premera and its subsidiaries
4 into for-profit corporations. And the state not-for-profit
5 corporate statutes do not have any mechanism built into them
6 whereby you can do that, unlike some other states. So the
7 way you have to do it in Washington is to go through a
8 dissolution process.

9 Once you start down the road of going through
10 dissolution process, under the not-for-profit statute, you
11 need to look at what restrictions exist in your articles of
12 incorporation on disposition of your assets in a dissolution.
13 And in this case, the articles of Premera require that upon
14 dissolution, its assets be given to another not-for-profit
15 corporation. So I believe that is the reason that that
16 followed and why they wound up creating not-for-profit
17 foundations.

18 Q Do the articles of Premera require that the assets be given
19 to a nonprofit charitable corporation or just a nonprofit
20 corporation?

21 A Just nonprofit corporations having purposes consistent with
22 those of Premera.

23 Q So could the board, consistent with its fiduciary duties
24 under Washington law, Mr. Steel, decide to give the assets to
25 a charitable corporation as opposed to another nonprofit

1 corporation?

2 A Yes.

3 Q Is there anything in the fact that the foundations proposed
4 to be established in this case are charitable that says
5 anything about whether Premera itself is charitable
6 currently?

7 A No. I don't draw any inference from that fact.

8 Q All right. Let me ask you then, Mr. Steel, whether you
9 believe that Premera, as it currently exists, is a charitable
10 organization?

11 A No. I believe that it is basically a commercial operation.
12 The U.S. Congress recognized explicitly that these types of
13 healthcare insurers are, quote, "inherently commercial"
14 almost 20 years ago.

15 Q Do you believe that the assets of Premera, nonprofit Premera,
16 are impressed with a charitable trust, Mr. Steel?

17 A No, I do not. The way Washington law works on this is that a
18 showing of intent to impress charitable use restrictions on
19 particular assets is required in order to create a charitable
20 trust. And I am not aware of any facts that would support
21 that conclusion. And in fact, in light of the fact that all
22 or nearly all of Premera's assets have been derived from
23 payments by people who are purchasing insurance coverage, I
24 have stated my conclusion in my report that I had serious
25 doubts that it even could be shown that any significant

1 portion of its assets are subject to a charitable trust.

2 Q Premera, as you know, is currently organized as a nonprofit
3 corporation. Under Washington law, does that mean that
4 Premera, as a nonprofit, is a charitable corporation or that
5 its assets are impressed with a charitable trust?

6 A No. Washington law is very clear that simply because you are
7 a nonprofit corporation does not mean you're a charitable
8 organization or a charitable corporation. In addition,
9 Washington statutes are very clear that only a very limited
10 category of nonprofit corporations are legally entitled to
11 hold themselves out as operating for the benefit of the
12 public. And Premera does not fit within that category.

13 Q Does the fact that Premera is a nonprofit corporation mean
14 that it is owned by the public, Mr. Steel?

15 A No. The laws are quite clear that nonprofit corporations are
16 not owned by the public. And so therefore, Premera is not
17 either.

18 Q Now, yesterday we had admitted I think through testimony of
19 Mr. Marquardt early articles of incorporation of two
20 corporations that were ancestors of present-day Premera. Do
21 you recall that testimony, Mr. Steel?

22 A Yes, I do.

23 Q And I placed before you on the table the Intervenor's
24 exhibits. I would ask you if you would to look at
25 Intervenor's Exhibit I-7. Exhibit I-7 I believe the testimony

1 yesterday established was - is a document dating from 1933.

2 It's the articles of incorporation of Medical Service

3 Corporation of Spokane County. Is that correct?

4 A Yes.

5 Q Have you looked at the purposes clause in those articles of
6 incorporation, Mr. Steel?

7 A Yes, I have.

8 Q Do you believe that the purposes clause in those articles of
9 incorporation create a charitable trust or otherwise rendered
10 Premera, as successor to MSC, a charitable organization?

11 A I'm sorry. Can you repeat the question.

12 Q I'm sorry. Do you believe that the purposes clause in
13 Exhibit I-7 creates a charitable trust or otherwise renders
14 Premera a charitable organization?

15 A No. My review of the purposes clause here detects little or
16 no evidence of any charitable or any intent to create a
17 trust. In particular, I think I would draw your attention to
18 subparagraph G of article 3, which makes it clear that one of
19 the main purposes of this organization is going to be to
20 conduct and operate a business that is self-sustaining. And
21 that is consistent with what - the initial question that you
22 asked me about is Premera charitable in nature. No, it is
23 not. It's a commercial business. It's pretty clear from
24 this that this is intended to be a revenue-generating
25 business.

1 Q Would you turn to Exhibit I-6 in the same book, Mr. Steel. I
2 believe Exhibit I-6 is the original 1945 articles of
3 incorporation of the Washington Hospital Service Association.
4 Is that correct?

5 A Yes.

6 Q And have you reviewed the purposes clause in those articles?

7 A Yes, I have.

8 Q Did the purposes as set forth in the original articles of
9 incorporation of WHSA, which is a predecessor of Premera,
10 create a charitable trust or otherwise render Premera, as
11 successor to that corporation, charitable?

12 A No, not in my opinion. Again, it refers to its object as a
13 business object. And I think the closest it comes to
14 anything that might sound vaguely charitable in nature is the
15 language that is at the bottom of page 1, where it talks
16 about promoting the general and social welfare of such
17 persons as may become subscribers. Had it been just
18 generally limited to promoting general and social welfare,
19 maybe there might have been some argument based on that. But
20 by narrowing it down to subscribers, who are basically people
21 that pay for insurance coverage, I think that that takes it
22 out of the category of any charitable organization.

23 Q Apart from the purposes clause in the original articles of
24 incorporation, Mr. Steel, is it permissible for a nonprofit
25 corporation to amend its articles of incorporation?

1 A Before I answer, can I put this down?

2 Q Please.

3 A And the question was: Is it permissible for a nonprofit to
4 amend its articles of incorporation?

5 Q That was the question.

6 A The answer is yes. All of the nonprofit statutes in the
7 state of Washington have a provision in them that allows - in
8 relatively broad language allows the board or the members,
9 whoever is the governing body, to amend the articles.

10 Q Have you reviewed the current articles of Premera, Mr. Steel?

11 A Yes, I have.

12 Q Do the current articles of Premera reflect any charitable
13 purposes?

14 A No, they do not.

15 Q Does the fact that Premera had a federal tax exemption until
16 1986 render it charitable, either then or particularly today?

17 A No, I do not believe it does. The tax exemption that Premera
18 Blue Cross had, and I believe the one that MSC had as well,
19 were federal tax exemptions. But it is important to note, I
20 think, that the type of tax exemption that they had was not
21 the type that is typically applied for and granted to
22 charities. It was a 501(c)(4) exemption as distinguished
23 from 501(c)(3) exemption.

24 And I think it's important here to note that
25 legislative bodies, whether they be at the federal level or

1 state level, frequently will grant various tax benefits, tax
2 exemptions and other benefits, to a variety of business
3 organizations in order to promote various social purposes.
4 Examples of this would be the recent batch of tax breaks that
5 were given to Boeing in order to induce them to keep certain
6 production in the state of Washington. Other examples would
7 be the R & D tax credits that have been given to Microsoft
8 and other high-tech companies in order to induce certain
9 types of activities. And even though these obviously have
10 social benefit that arises out of them doesn't mean that
11 Boeing or Microsoft is a charitable organization.

12 Q Mr. Steel, the OIC Staff's consultants have voiced a number
13 of criticisms of Premera's Form A that are based on the
14 notion that all of Premera's assets are subject to a
15 charitable trust. How do you respond to those criticisms?

16 A Well, I think that they're without legal foundation. As I
17 indicated earlier, the way the Washington law works on this
18 is that you need to go through a factually-intensive inquiry
19 in order to attempt to determine whether there has been at
20 some point an intent to impose charitable use restrictions on
21 particular assets. And in my own review of the situation and
22 also in the OIC consultants' reports, I don't see any
23 foundation for such a conclusion. In fact, my understanding
24 is, as I said before, that rather than examine that question,
25 I believe the OIC consultants were instructed to simply

1 assume the existence of a charitable trust rather than look
2 at the question.

3 Q Now is it appropriate, in your judgment, Mr. Steel, to assume
4 that Premera is a charity or that its assets are subject to a
5 charitable trust?

6 A No. Again, it requires a factual inquiry in order to arrive
7 at the conclusion of a charitable trust under Washington law.
8 You cannot simply presume it. In fact, if there is any
9 presumption to be drawn around that issue, I think it would
10 go the other way. In other words, I think you would assume
11 that assets are not subject to a charitable trust unless
12 there has been a factual demonstration that there was an
13 intent to impose use restrictions.

14 And so this assumption is inappropriate, in my view,
15 not only because it avoids the necessary factual inquiry, but
16 in addition, it - I think the inappropriateness of it can be
17 easily demonstrated from you look at the case law in other
18 jurisdictions where courts have actually gone into the
19 factual inquiry of - as to the question of are Blue
20 Cross/Blue Shield licensees charitable in nature and are
21 their assets held subject to charitable trust. Those courts
22 that have actually engaged in that inquiry have all come out
23 with the conclusion that no, they are not charities and their
24 assets are not subject to charitable trusts.

25 So if you stack up this assumption that Premera is a

1 charity or that its assets are subject to a charitable trust
2 against that other case law, I think it's just completely
3 inappropriate.

4 Q Many of the OIC Staff's consultants' criticisms of the Form A
5 involve the assertion that Premera is obligated to maximize
6 the amount of money that goes to the foundations. How do you
7 respond to that, Mr. Steel?

8 A I'm not aware of any principle of Washington law that would
9 require Premera in these circumstances to maximize its
10 contributions to the foundation. The OIC consultants'
11 reports certainly make that argument. And I believe they
12 premise it on two things. One is first this assumption that
13 Premera's assets are subject to charitable trust
14 restrictions, which, as I already indicated, I think is
15 completely inappropriate. And furthermore, I think if we
16 were to delve into the facts, I believe it is extremely
17 unlikely that any significant portion of Premera's assets
18 could be shown to be subject to charitable trust
19 restrictions. So that first basis for this maximization
20 theory, I think it just - it doesn't support it.

21 The second is that the OIC consultants attempt to
22 analogize from RCW Chapter 70.45, which is the nonprofit
23 hospital conversion statute, and attempt to infer certain
24 rules or ways of looking at the problem from that statute
25 into this proceeding. And as I indicate in my report, I

1 think that's completely inappropriate as well, especially
2 when you consider that the Legislature, when it adopted that
3 statute, had in front of it a broader model act that would
4 have applied to healthcare insureds such as Premera. And yet
5 it consciously refrained from applying that statute to this
6 situation. So I think reasoning by analogy from that statute
7 is just not appropriate.

8 So at the end of the day, what I'm left with is that
9 what we have here is simply a situation where Premera has
10 made a business decision that has resulted in a conclusion by
11 the Premera board that they should, as a voluntary matter, in
12 order to be in accordance with their own articles, contribute
13 their assets to charitable foundations. And there is no
14 principle under Washington law that requires Premera or me or
15 any other donor of charitable assets to maximize how much
16 they give.

17 Q I understand, Mr. Steel, that you believe the assumption to
18 be inappropriate. But if one were to assume that at least
19 part of Premera's assets are subject to charitable
20 limitations, does the proposed conversion, in your judgment,
21 satisfy the transfer requirements of the Washington Nonprofit
22 Corporation Act?

23 A Assuming that a showing were made that some portion of
24 Premera's assets were subject to charitable trust
25 restrictions, the answer would be yes. That would implicate

1 the language that is in section 24.03.225 sub three, which
2 would then require that those particular assets be
3 transferred to an entity that has substantially similar
4 purposes.

5 Now, if a showing were made that some of Premera's
6 assets were subject to charitable trust restrictions, I can
7 only think that the nature of those restrictions would be
8 something related to the health of the public. Otherwise I
9 can't imagine why anybody would give assets to Premera
10 subject to charitable use restrictions. And I think that
11 those - if you indulge that assumption, I think that it is -
12 it seems extremely similar to the purposes of the
13 foundations, in my mind.

14 If I'm - might elaborate on the question just for a
15 second, you asked the question what if you were to assume
16 that a portion of Premera's assets was subject to charitable
17 trust restrictions. And I think one thing that is very
18 important to note here is that even if it were shown that a
19 portion of the assets were subject to charitable trust
20 restrictions, that doesn't mean, therefore, that Premera, as
21 a whole, is a charity or that all of its assets are subject
22 to charitable trust restrictions. It doesn't work that way.

23 In other words, to use let's say Microsoft as an
24 example again, if I wrote out a check to Microsoft
25 Corporation and mailed it off with a letter saying, "Please

1 use this for the health of these residents of the state of
2 Washington," and Microsoft was foolish enough to not send it
3 back to me and instead cashed the check and put it in their
4 checking account, they would hold \$100 or whatever the amount
5 of the check was subject to charitable trust restrictions.
6 But that doesn't mean that all of Microsoft would be subject
7 to charitable trust restrictions; only those assets.

8 Now, taking that concept a little bit further though,
9 if I were to assume, rather than as you asked me to, rather
10 than assume that a portion of Premera's assets are subject to
11 charitable trust, if I were to assume that all of them are -
12 which I am of the opinion that could not possibly be shown -
13 but if I were, for the moment, to assume that, frankly, my
14 opinion would still be the same. I believe that even then,
15 the requirements of 225 sub 3 would be met.

16 Q Mr. Steel, what do you think about the impact of the proposed
17 conversion on the amount of assets that will be dedicated to
18 charitable use in this state as well as in Alaska?

19 A Well, I think it will clearly have a dramatic impact. It
20 will dramatically increase the amount of assets that are
21 available for application to charitable uses in the state of
22 Washington and Alaska. The problem currently, of course, is
23 that even if you were to assume that all of Premera's assets
24 were subject to charitable use restrictions, the problem is
25 currently they're locked up in illiquid form and are used as

1 part of the operating assets of the business. So really
2 there's only a negligible amount annually that is actually
3 available for charitable uses.

4 Q I want to switch gears if I might, Mr. Steel, and ask you a
5 little bit about the board and its fiduciary duties. My
6 first question to you, Mr. Steel, is this: Under Washington
7 law, to whom or to what does the director of a nonprofit
8 corporation owe a duty?

9 A The duty of a director of a not-for-profit corporation is
10 described in the statute. And it describes it as a duty that
11 is owed to the corporation.

12 Q Does this duty change if one is the director of a for-profit
13 corporation?

14 A No. Actually the language of the statute is virtually
15 identical. Both for-profit and not-for-profit directors owe
16 their duty primarily to the corporation.

17 Q Now, did you have occasion as part of your work in this
18 matter, Mr. Steel, to look at board minutes and related
19 materials associated with the period leading up to the
20 decision to pursue a conversion?

21 A Yes, I did.

22 Q And based upon that review, Mr. Steel, could you tell us
23 whether the Premera board fulfilled its fiduciary duties
24 specifically with respect to considering alternatives to
25 conversion?

1 A In my view, they did. They conducted a - well, as you know,
2 a very, very lengthy multi-year analytical process that
3 reviewed a variety of alternative ways of addressing their
4 capital needs. They reviewed not only alternative sources of
5 capital, but actually took some steps to access some
6 alternative sources of capital. And they reviewed other
7 alternative methods such as combining with other businesses
8 and reviewed the likely candidates on a case-by-case basis as
9 to what the pros and cons of each of those would be and how
10 well they would meet the objectives the board had articulated
11 for itself.

12 Q Did the deliberative process followed by the Premera board
13 meet the requisite standard of care, Mr. Steel?

14 A Yes. You know, my view of the deliberative process as a
15 whole is that first, as I indicated, it was an extremely
16 thoughtful and careful deliberative process that was
17 supported by a number of different experts that the board
18 called in to advise them, including Goldman Sachs. The
19 decision at the end was made by the board, not by management.
20 It was a board-driven process.

21 I do not believe that there was any indication of
22 self-interest on the part of this board that would taint that
23 conclusion. The decision was certainly not arrived at in
24 haste, but it was arrived at in a timely manner. And what I
25 mean by that is that the predominant or one of the

1 predominant duties of a board member is to act prudently.

2 And if you think about what does prudent mean, what it really
3 means in the context of a director of a business operation is
4 that you need to sit back and think strategically. You need
5 to look at the horizon. You need to anticipate what are the
6 risks that might confront you in the future and what are the
7 needs that might confront you in the future. Your obligation
8 is not to wait until there is an emergent need for something,
9 but rather to anticipate. That's inherent in prudence. And
10 this board did that. They did not wait until the capital
11 need was an emergency. They're taking action now, in
12 anticipation.

13 So on the whole, what I conclude is that the board -
14 finally getting around to answering your question - the board
15 did meet the duty of care that is prescribed in the statute.
16 And as a result, I believe their decision is entitled to the
17 protection of the business judgment rule and should be
18 entitled to deference and should not be second-guessed.

19 Q I want to switch horses once more, Mr. Steel, and talk to you
20 a little bit about the structure of the transactions
21 associated with this conversion. In your opinion, Mr. Steel,
22 is the overall structure of the arrangements between New
23 Premera and the foundations, including what's reflected in
24 the registration rights agreement, the voting trust and
25 divestiture agreement and the transfer grant and loan

1 agreement reasonable and customary?

2 A Yeah. In general, I believe those are relatively commonplace
3 kind of restrictions to put into place for a situation like
4 this.

5 Q More specifically, Mr. Steel, do you believe that the
6 restrictions on the foundations set forth in these documents
7 are reasonable?

8 A Yes, and necessary I think. And the reason I say that is
9 that in my view, we're looking at a situation where you have
10 a commercial enterprise that holds assets that are not
11 subject to charitable trust restrictions and their board has
12 made a decision that as part of their dissolution process and
13 as part of complying with their articles, they're going to
14 transfer their assets to charitable foundations. And as I
15 indicated earlier, the only way you can impose a charitable
16 trust in Washington state is through a clear expression of
17 your intent to impose charitable restrictions. So those
18 types of restrictions that are imposed in foundation
19 organizational documents are not only reasonable, but
20 necessary in order to accomplish that.

21 Q With respect to the holding of stock by the foundations, at
22 least over the time that the foundations hold the stock and
23 before it is fully monetized, as we say, do you believe those
24 restrictions are reasonable?

25 A Yes. The thing that needs to be recognized in a situation

1 like this is that when you take the company public,
2 particularly when you have a large shareholder . . . And
3 this isn't the only type of instance where you run into this
4 problem. you'll encounter this also in situations where a
5 large company is trying to spin off a portion of their
6 business. And after they do that, they're going to be a
7 large shareholder, and only a portion of the company is going
8 to be sold to the public. In those instances, the public,
9 just by its nature I think, is relatively suspicious of
10 several things. One is they're worried about the dominance
11 of that large shareholder and whether that large shareholder,
12 through its voting power, might have the ability to contort
13 what direction the newly-public business is taken, whether
14 the large shareholder might have its own agenda that is
15 different from that of the public shareholders.

16 And in a situation like this, you can kind of see how
17 that suspicion might be somewhat well-founded because here
18 the foundations I believe are principally going to be
19 motivated to monetize their holdings quickly and get on with
20 the business of grant making. In other words, they're
21 divestors, not investors. And so that suspicion element is
22 there.

23 And the second is that the public market, even as much
24 as it wants the large shareholder in these circumstances to
25 gradually divest, the public market is worried about the

1 impact that divestiture will have on the day-to-day trading
2 price of the stock. In other words, dumping large amounts of
3 stock on the public market, you know, in an uncontrolled or
4 unplanned method or pattern could cause great volatility.
5 And so the public markets also like to see a lot of
6 predictability. They like to have visibility and do, you
7 know, "What is the plan for gradually divesting your
8 holdings?"

9 And at this point, I've forgotten exactly what your
10 question was. I'm sorry.

11 Q It wasn't nearly as memorable as the answer, Mr. Steel. But
12 let me ask a follow-on question. With respect to the voting
13 trust and divestiture agreement in particular, do I
14 understand your testimony to suggest that such agreements are
15 used in contexts other than conversions and that they have
16 utility beyond the conversion context?

17 A Oh, yes. Yeah. I mean a typical example would be the one I
18 mentioned earlier in the spin-off context.

19 Q So let me ask you about this scenario, Mr. Steel. A most
20 unlikely and certainly most unwelcome scenario sometime in
21 the future would be that Premera would lose its license to
22 use the Blue Cross/Blue Shield marks. Do you believe that in
23 that circumstance, that the restrictions in the voting trust
24 and divestiture agreement should expire or disappear?

25 A No, because, well, for one, I think even if Premera were not

1 a Blue Cross licensee today, on the eve of going public, the
2 underwriters would be raising exactly the same questions in
3 an effort to give as much comfort as possible to the public
4 investors. In other words, there is a lot of value, I think,
5 in giving those assurances, partly because it affects the
6 pricing and the IPO and, therefore, minimizes the amount of
7 dilution that the foundations themselves are going to suffer,
8 but also because it's important to have those kinds of
9 assurances in place so that the public, you know, feels a
10 degree of comfort and so that the - if looked at from the
11 foundations' perspective, so that the public market knows
12 that there's going to be selling going on on a regularized
13 basis and is receptive to it.

14 So even if Premera were not a licensee, I think we
15 would see the underwriters raising those kinds of issues.

16 In the particular instance that you hypothesized where
17 Premera goes public as a licensee and then loses the license,
18 I guess the comment I would make would be in that
19 circumstance, I think it's going to be even more important to
20 have those kinds of things in place in order to help
21 stabilize the market, because the company and its stock price
22 will already be under a lot of pressure if it loses its Blue
23 Cross license. And what you don't need is for public
24 investors to freak out in that circumstance and feel that
25 there's going to be - you know, either the foundation's sort

1 of taking control of the company all of a sudden or something
2 of that nature.

3 Q Do you believe, Mr. Steel, that the divestiture schedule
4 proposed in Premera's Amended Form A will degrade or
5 adversely affect the value of the foundations' stock?

6 A No. Just the opposite. As I mentioned, I think that the
7 presence of these restrictions will - first, it will help the
8 pricing in the IPO. And thus immediately after the IPO, the
9 foundations, in my view, will own a higher percentage of the
10 company than they would have otherwise because less dilution
11 will be required in order to raise the same amount of money.

12 And then secondly, these kinds of assurances given to
13 the public markets generally provide comfort and help provide
14 more stability in the trading market and a receptiveness to
15 the ongoing trading activity.

16 Q My final question, Mr. Steel, relates to the unallocated
17 shares escrow agent agreement, a very lengthy title for an
18 agreement I guess we can call the escrow agreement. Do you
19 believe that the escrow agreement proposed in this case is a
20 reasonable and customary mechanism for dealing with
21 distribution of assets pending the resolution of the dispute?

22 A Yes. I would - I think that it is a - the kind of - a kind
23 of commonplace mechanism that just about anybody would turn
24 to in a situation where there's a pending dispute that is -
25 that otherwise would get in the way of, you know, of a

1 business transaction, very common method.

2 MR. MITCHELL: I have no further questions.

3 MR. HAMJE: Good morning, Mr. Steel.

4 THE WITNESS: Good morning.

5

6 CROSS-EXAMINATION

7

8 BY MR. HAMJE:

9 Q Mr. Steel, would you describe this transaction that we're
10 here about today as a commonplace transaction?

11 A No.

12 Q Mr. Steel, you haven't represented any parties in any Blue
13 Cross or Blue Shield conversions prior to your engagement in
14 this matter?

15 A Correct.

16 Q And you have never represented the Blue Cross/Blue Shield
17 Association?

18 A Correct.

19 Q If I understand your testimony correctly, in your opinion,
20 the Attorney General has the responsibility for ensuring that
21 the restrictions under the statute we referred to in your
22 testimony, RCW 24.03.225 sub 3, are met; is that correct?

23 A I don't believe I testified to that this morning. But that
24 is my view, yes.

25 Q Well, I understand. But you did testify in your deposition

1 to that; is that correct?

2 A Yes.

3 Q When a nonprofit dissolves that holds assets subject to
4 subsection 225 (3), it's required to notify the Attorney
5 General's Office, that is provide a copy of its plan of
6 distribution; is that correct?

7 A Yes.

8 Q And that's under another statute. That's RCW 24.03.230; is
9 that correct?

10 A Yes.

11 Q You were not knowledgeable about the process that is followed
12 with respect to providing notification to the Attorney
13 General's Office in that regard; is that right?

14 A Well, you asked me what did I know about it other than what
15 the statute says. And I told you that I didn't know anything
16 about it other than what the statute says.

17 Q So that's the limit of your knowledge is just what the
18 statute says?

19 A Yes.

20 Q And you haven't been involved yourself in actually providing
21 that notice along those lines to the Attorney General's
22 Office; is that correct?

23 A No.

24 Q If there are no assets subject to charitable trust
25 limitations under subsection 225 sub 3, then there is no need

1 or obligation for a dissolving nonprofit company to provide
2 notice of such a plan of distribution under subsection 230,
3 is there?

4 A No. There's certainly no obligation to do it under sub 230.
5 I would agree with that.

6 Q Yes, sir. Now, Mr. Steel, you are not saying that you
7 reviewed materials and came to the conclusion that it is not
8 possible to make a showing that some assets received by
9 Premera or its predecessors was received with charitable use
10 limitations; is that correct?

11 A I think I understand your question. I am not saying that
12 it's impossible to show that there might have been some that
13 were given to Premera with charitable use restrictions
14 attached.

15 Q And you did not review Premera's organizational history
16 except possibly to the extent that you reviewed some of the
17 documents that Mr. Mitchell showed to you and talked to you
18 about in your testimony today; is that right?

19 A Yeah. I reviewed the documents that have been filed as
20 Intervenors' exhibits.

21 Q And in fact, it was not part of your charge to conduct a
22 factual inquiry to determine whether any of Premera's assets
23 are subject to charitable limitations; is that correct?

24 A I was not asked to prove the negative, no.

25 Q And you have never been involved in conducting such a factual

1 inquiry for any of your clients; is that right?

2 A To prove the negative? No. I don't know why one would do
3 that.

4 Q Now, you have stated that the proposed transfer of assets to
5 the Washington and Alaska foundation shareholders is a purely
6 voluntary act on the part of Premera; is that correct?

7 A I have, yes. That is what I've stated.

8 Q And this is for the reason that Premera is under no legal
9 obligation to transfer the assets as proposed; is that right?

10 A It is under no legal obligation to dissolve. And it is - and
11 when it chooses to dissolve, it is under no legal obligation
12 to transfer them to a charity.

13 Q And so therefore, you concluded as a voluntary donor, Premera
14 is entitled to impose any restrictions upon the use of the
15 assets as Washington law allows; is that correct?

16 A Yes.

17 Q Is this Premera's position?

18 A I don't . . . I believe it is. All I'm saying is what my
19 opinion is.

20 Q Is it your position that Premera is not obligated to transfer
21 the fair market value of its assets upon dissolution to the
22 foundation shareholders?

23 A I believe the only - the only obligation that I see that is
24 on Premera in this circumstance is to comply with its
25 articles, which requires it to transfer its assets to another

1 nonprofit entity that has consistent purposes.

2 Q So is your answer to my question yes?

3 A I see no other obligations, including the one you mentioned.

4 Q Do you know if this is Premera's position?

5 A I do not know for sure. But I would guess it is. It is my
6 opinion.

7 Q You will concede that there is no legal prohibition against
8 transferring the fair market value of its assets upon
9 dissolution to the foundation shareholders; is that correct?

10 A I'm sorry, Mr. Hamje. One more time.

11 Q Will you concede that there is no legal prohibition against
12 transferring the fair market value of its assets upon
13 dissolution to the foundation shareholders?

14 A No. I'm not aware of one.

15 Q So you do concede that point?

16 MR. MITCHELL: Object to the question as
17 argumentative. I think this was affirmative testimony by the
18 witness.

19 JUDGE FINKLE: Sustained.

20 Q (BY MR. HAMJE) Well, will you concede that Premera has a
21 legal right to agree to transfer the fair market value of its
22 assets upon dissolution to the foundation shareholders?

23 MR. MITCHELL: Same objection.

24 JUDGE FINKLE: Just change "concede" to "would you
25 agree" and you can ask the same question.

1 Q (BY MR. HAMJE) Will you agree that Premera has the legal
2 right to agree to transfer the fair market value of its
3 assets upon dissolution to the foundation shareholders?

4 A Do you mean could Premera enter into a contract to do so?

5 Q Yes, to agree to go ahead and transfer the assets as I've
6 stated.

7 A That they could enter into an agreement to transfer the fair
8 value of their assets, yes.

9 Q Mr. Steel, in your supplemental report, which is P-87, at
10 page 3 --

11 A Do I have that here?

12 Q I don't know.

13 A All right. Well, I have it in this. Go ahead.

14 Q At page 3, on P-87, footnote 3, you quote language from an
15 exhibit to a letter to the effect that Premera is not a
16 charity; is that correct?

17 MR. MITCHELL: I'm sorry, John. Supplemental
18 report?

19 MR. HAMJE: P-87, page 3, footnote 3.

20 A Yeah. What I was doing here in this footnote is addressing
21 the statement from the OIC consultants' documents where they
22 asserted that there was no disagreement among the parties
23 that the value of Premera must be paid to the public as part
24 of the conversion. And I was pointing out that based on
25 certain documents that I had in my possession at the time I

1 wrote my report, my supplemental report, I didn't believe
2 that that was correct.

3 Q (BY MR. HAMJE) So you have located that - that passage that
4 I was asking you about?

5 A Oh, I'm sorry.

6 HAMJE: Your Honor, may I approach the witness?

7 JUDGE FINKLE: Yes.

8 Q (BY MR. HAMJE) Mr. Steel, I've just handed you a copy of an
9 exhibit that has been presented by the OIC Staff entitled
10 S-86. I'd like you to take a look at it and I want to make
11 sure that you can identify it as being the letter with the
12 exhibit, Exhibit 7, that you're referring to in your report
13 attached to it. I think the specific language that you're
14 referring to in your footnote can be found on page 3 of
15 Exhibit 7.

16 MR. MITCHELL: Where on page 3, counsel?

17 MR. HAMJE: Of Exhibit 7. The second bullet point
18 at the top of the page.

19 MR. MITCHELL: Counsel, I think that the passage
20 to which you should be directing the witness's attention is
21 the first bullet, not the second bullet on the page.

22 MR. HAMJE: I'm sorry. You're correct. Thank
23 you, sir.

24 Q (BY MR. HAMJE) Is that the correct passage, the first bullet
25 point on that page?

1 A Yes.

2 HAMJE: At this time the Staff would move for
3 admission of S-86.

4 MR. MITCHELL: Your Honor, notwithstanding the
5 unreliability of the source, we have no objection.

6 JUDGE FINKLE: Admitted.

7 Q (BY MR. HAMJE) Let's go ahead. I'd like to read that first
8 bullet point to you. It's - you say that - it says, "The
9 C & B draft report asserts that conveyance of Premera's fair
10 market value is the fundamental legal requirement for
11 satisfaction of the public's stake in the company," and
12 quotes - cites executive summary. "If there is any authority
13 to support this statement, it should be cited. Otherwise the
14 assertion should be stricken as an unsupported assumption.
15 Contrary to the apparent premise, Premera is not a charity.
16 Absent a conversion, none of its value will be given over to
17 charitable purposes."

18 Did I read that correctly?

19 A Yes.

20 Q Then the second bullet point goes on, "The C & B draft report
21 suggests at page 41 that there is an apparent agreement among
22 all parties that PBC," which is Premera Blue Cross, "PBC's
23 fair market value must ultimately be transferred to the
24 foundation shareholder. Premera has never agreed to this
25 proposition. Premera has agreed only that it will transfer

1 100 percent of its stock to the foundation shareholder, which
2 represents the fair market value of the company upon
3 consummation of the conversion transaction."

4 Did I also read that correctly?

5 A Yes.

6 Q Do you agree with that - the statement in the second bullet
7 point?

8 A Yes.

9 Q Is it your understanding that it was submitted by Premera's
10 counsel, as unreliable as he may be?

11 A You wish me to comment on his unreliability?

12 Q No. I could not - I just could not contain myself. I
13 apologize.

14 A Neither could I. I'm sorry. The question again was: Is it
15 from Premera's --

16 Q Is it your understanding that this was submitted by Premera's
17 counsel?

18 A Yes.

19 Q You were not counsel for Premera in this matter; is that
20 right?

21 A Correct.

22 Q If 100 percent of its stock represents the fair market value
23 of the company upon consummation of the conversion
24 transaction, and Premera proposes to transfer 100 percent of
25 its stock to the foundation shareholders upon dissolution,

1 isn't that equivalent to proposing to transfer the fair
2 market value of its assets upon dissolution to the foundation
3 shareholders?

4 A I suppose, yes.

5 Q Mr. Steel, I'd like to now refer to your pre-filed direct
6 testimony, which I believe is Exhibit P-84.

7 A Okay.

8 Q And I'd like you to take a look at page 30, please. And if
9 you'd take a look at line 12 and that discussion there.
10 You're talking about director independence; is that correct?

11 A Yes.

12 Q Isn't it true that the voting trust and divestiture
13 agreement, which I understand is Exhibit G-4 that's attached
14 to Revised Form A, which I believe is Commissioner's
15 Exhibit 2, contemplates that in many instances, the
16 Washington foundation shares of Premera's stock
17 post-conversion and IPO will be voted consistent with the
18 majority of the independent directors of Premera. Is that
19 right? Is that your understanding as well?

20 A Yes.

21 Q And that involves, for instance, the election of Premera's
22 directors; is that right?

23 A The selection of nominees.

24 Q Selection of nominees?

25 A Right.

1 Q And against removal of any of Premera's directors; is that
2 right?

3 A Yes.

4 Q Now, the test for eligibility to serve as an independent
5 director includes whether the director or his or her employer
6 accounts for two percent of Premera's revenue or \$1 million,
7 whichever is greater; is that correct?

8 A Yes.

9 Q And this is found in Article 2 of Section 4, Subsection F, of
10 New Premera's bylaws.

11 MR. MITCHELL: I would object, your Honor. I
12 think the witness is being asked about specific language in
13 documents without being afforded the opportunity to look at
14 it. And I'm not sure that the recitations are necessarily
15 complete.

16 JUDGE FINKLE: Well, the witness can - is a
17 sophisticated witness.

18 I think if you need more information, you'll let us
19 know. Otherwise the question will be allowed.

20 HAMJE: All I was doing in the second part of it
21 was just to identify it as part of Exhibit B-2 to the Revised
22 Form A, which is Commissioner's Exhibit 2.

23 Q (BY MR. HAMJE) If a director's company accounts for an
24 amount less than two percent of New Premera's revenues, which
25 amount could be more than \$1 million, then that person would

1 be eligible to be termed an independent director; is that
2 correct?

3 A Yes.

4 Q And the reverse is true, is it not, that if New Premera is
5 receiving an amount from the director's company that's less
6 than two percent of the company's gross revenues or
7 \$1 million, whichever is greater. Is that correct as well?

8 A Less sure about that one. I'd need to look at the language
9 of it.

10 Q I happen to have that here with me.

11 A I figured you might.

12 HAMJE: If I may approach the witness.

13 JUDGE FINKLE: Yes.

14 Q (BY MR. HAMJE) What I've done is I've handed you Article 2
15 out of the Exhibit B-2 to the Revised Form A, which is
16 pages 3, 4, 5, 6 and 7 of the bylaws of the new Premera
17 corporation. And specifically, if you would look at
18 Article 2, section 4F, does that refresh your recollection as
19 to whether the reverse is true in connection with what a
20 candidate for an independent director's eligibility would be?

21 MR. MITCHELL: Object to the form of the question.
22 I think enough time has elapsed that we need to have an
23 affirmative statement of what it is that's being asked.

24 HAMJE: Let me give him a chance first to finish
25 reading the section. Then when he's ready, then I'll ask him

1 a question again.

2 A Okay. I'm ready.

3 Q (BY MR. HAMJE) If New Premera is receiving an amount from
4 the director's company that is less than two percent of the
5 company's gross revenues or \$1 million, whichever is greater,
6 then that person would be eligible to be termed an
7 independent director; is that correct?

8 A Yes.

9 Q Are you aware of the amount of Premera's 2003 revenue?

10 A No.

11 Q Let me ask you to assume for a moment that that revenue is -
12 it was 2 point 834 - \$2,834,000,000. Will you do that?

13 A Sure.

14 Q Two percent of that, can you calculate that? Or maybe I
15 should --

16 A Help me out.

17 Q I will. I do have something I think that will . . .

18 HAMJE: May I approach the witness?

19 JUDGE FINKLE: Yes.

20 A What was the number again, Mr. Hamje?

21 Q (BY MR. HAMJE) You may not - I don't know if the digits on
22 that little calculator are going to go all the way. But if
23 we can do it in thousands. It would be two billion
24 834 thousand . . . I'm sorry. \$2,834,000,000. If you'd
25 multiply that by two percent.

1 A Roughly 56 million.

2 Q 56 million plus; right?

3 A Yes.

4 Q Therefore, applying the new Premera test, a director whose
5 company accounts for 57 - or \$56 million plus, using the 2003
6 figures, would be eligible to serve as an independent
7 director; is that correct?

8 A Up to that point, yes.

9 Q Yes. Mr. Steel, I don't think you're going to need that
10 calculator again.

11 A Okay.

12 Q Mr. Steel, if you'd refer to your supplemental report, which
13 I understand is P-87, please. On page 2, you state near the
14 bottom of the page in the text that in your view, the most
15 important legal issue in connection with the Amended Form A
16 filing is whether Premera is a charitable corporation or
17 whether its assets should be impressed with a charitable
18 trust; is that correct?

19 A That's what I said, yes.

20 Q Are you suggesting that this is an issue that the
21 Commissioner must determine in this proceeding?

22 A No.

23 Q In fact, you've made no effort in analyzing what the
24 Commissioner's scope of authority is in this proceeding; is
25 that right?

1 A No. This comment here is made because so many of the OIC
2 consultants' criticisms are based upon the assumption that
3 there's a charitable trust.

4 Q But you haven't made any effort in analyzing what the
5 Commissioner's scope of authority is in this proceeding; is
6 that correct?

7 A I don't pretend to be an expert on insurance law or
8 regulations.

9 Q And you haven't looked at the criteria that the Commissioner
10 is supposed to apply in this proceeding; is that right?

11 A No, I have.

12 Q You have? Have you analyzed that criteria?

13 A I'm not sitting up here as an expert prepared to testify that
14 my opinion is this or that on that - on those.

15 Q In fact, your analysis of the Holding Company Act has been
16 limited to whether a healthcare insurer is or is not
17 charitable in nature; is that correct?

18 A No. I mean for one, I don't believe that that really is an
19 issue that arises under the Holding Company Act. And in
20 addition, as you know from my deposition, we've had
21 conversation on other aspects of the Holding Company Act.

22 Q Didn't you tell me during - when I did take your deposition
23 that your analysis of the Holding Company Act was limited to
24 whether a healthcare insurer is or isn't charitable in
25 nature? Do you recall telling me that?

1 A No, I don't.

2 HAMJE: Excuse me. May I approach the witness?

3 JUDGE FINKLE: Yes.

4 HAMJE: Your Honor, it may very well be that we
5 gave you the first deposition instead of the second one.

6 JUDGE FINKLE: November 26th.

7 HAMJE: Yes. That was the wrong one. Here is the
8 right one. I apologize.

9 JUDGE FINKLE: Okay.

10 HAMJE: Kind of hard to open sometimes.

11 Q (BY MR. HAMJE) If I could ask you and your counsel to turn
12 to page 19 of your deposition, please. I'm sorry. Page 18.
13 If you would look at line 19.

14 I asked you, "Did you, in preparing your supplemental
15 report, analyze whether Chapters 48.31B or 48.31C or both
16 have an impact on the charitable trust issues?"

17 Your answer was, "Somewhat. I did analyze it as I set
18 forth in the supplemental report. We did analyze the purpose
19 of the Holding Company Act and whether the legislative
20 history does or doesn't support the view that its purpose is
21 to protect charitable assets."

22 Is that accurate?

23 A Yes. Now I recall my - my testimony and the reason I said
24 that.

25 Q Mr. Steel, you have no experience regarding the insurance

1 regulatory side of Form A's; is that correct?

2 A No. I'm not a regulatory lawyer.

3 Q In fact, your experience with acquisitions of health carriers
4 is limited to the sale of a healthcare insurer in the mid
5 nineties; is that right?

6 A No. I've sold several insurance companies.

7 Q Well, didn't you tell me that --

8 A Only one healthcare insurer.

9 Q That's what I'm asking about, just a healthcare insurer.

10 A Right.

11 Q That is correct?

12 A Correct.

13 Q In that transaction, you were not involved in the process of
14 obtaining insurance regulatory approvals, were you?

15 A No.

16 Q I understand that you also believe that the whole discussion
17 of fair value is largely superfluous; is that correct?

18 A Yes.

19 Q You were not sure that the discussion of fair value is
20 relevant to the Holding Company Act; is that correct?

21 A Correct.

22 Q Are you suggesting that the question of fair value is not one
23 that should be addressed by the Commissioner in this
24 proceeding?

25 A Again, I haven't made any judgments about what the

1 Commissioner ought or ought not address.

2 Q You believe that the Holding Company Act specifically
3 addresses conversion of not-for-profit health carriers; is
4 that correct?

5 A Well, given the fact that the only way to convert in this
6 state - under corporate laws, the only way to do it is to
7 engage in a series of transactions of the type that Premera
8 has proposed here, yes. Those statutes - those regulatory
9 statutes do apply.

10 Q But you would agree that there is no statutory process for
11 converting a nonprofit health carrier to a for-profit health
12 carrier; is that right?

13 A There's no direct route. You have to go through this
14 circuitous route.

15 JUDGE FINKLE: Mr. Hamje, about how much longer do
16 you expect to be? Just trying to time the break.

17 MR. HAMJE: I think another 20 to 30 minutes at
18 the most.

19 JUDGE FINKLE: Why don't we take a break.

20 (Morning recess.)

21 JUDGE FINKLE: Ready to proceed. I want to give
22 you a ruling on the motion so that you'll be able to
23 incorporate it into your plans. The testimony will be
24 concluded before OIC Staff's recommendation. Testimony
25 relating to that recommendation is required. Of course, may

1 be made at an earlier date. Premera will have no less than
2 an evening to respond to that testimony - that is regardless
3 of the time of day that that testimony is completed - subject
4 to whatever examination Intervenors wish to make at that
5 time. We'll recess for the day at Premera's election and
6 resume the following morning with cross-examination. Of
7 course, Premera may elect to take a shorter recess. But you
8 will be given that option.

9 If that results in the hearing requiring an extra day,
10 so be it; we'll be in session on Wednesday. I would hope
11 that the testimony would be presented by Monday and therefore
12 we would not have to delay the conclusion of the hearing.
13 But if we need to, we will. The facility's available. The
14 Commissioner has agreed to be available himself.

15 MR. HAMJE: Your Honor, may I - maybe I missed the
16 very beginning of your ruling. Are you granting the motion?

17 JUDGE FINKLE: Well, no.

18 MR. HAMJE: I'm sorry.

19 JUDGE FINKLE: I'm neither granting it nor denying
20 it. The testimony of OIC Staff as to its position on
21 conversion may be deferred until the conclusion of the
22 evidence in the case in chief, including the Intervenors'
23 witnesses.

24 MR. HAMJE: I think understand now.

25 JUDGE FINKLE: It is not required that it be

1 deferred. And I think a lot of people would be happy if it
2 weren't. But it may be.

3 MR. HAMJE: Thank you, your Honor.

4 JUDGE FINKLE: Did you get the rest of the ruling?

5 MR. HAMJE: I think I understand it now. I just
6 missed the first part of it.

7 JUDGE FINKLE: Are we ready to proceed then?

8 MR. HAMJE: I'm ready.

9 Q (BY MR. HAMJE) Mr. Steel, if you would take a look at your
10 pre-filed direct testimony again, which is Exhibit P-84. And
11 if you would look at page 27 of that - of your testimony and
12 line 17 on that page as well. Have you located it, sir?

13 A Yes.

14 Q You reference there several restrictions imposed upon the
15 foundation shareholders that are mentioned in the Cantilo &
16 Bennett supplemental report; is that correct?

17 A Page 27, line 17?

18 Q Page 27, line 17.

19 A Yes.

20 HAMJE: Have you found it, counsel?

21 MR. MITCHELL: Yes.

22 Q (BY MR. HAMJE) And your answer to my question was yes; is
23 that correct?

24 A The question being have I found it?

25 Q Well, where you reference several restrictions imposed upon

1 the foundation shareholders --

2 A Yes.

3 Q -- that are mentioned in the Cantilo & Bennett report. One
4 of those restrictions is lobbying is permitted as long as it
5 is not materially adverse to health insurers; is that right?

6 A Yes.

7 Q And another one, there is a prohibition from using Premera's
8 assets as initiatives, et cetera, that likely would result in
9 material adverse changes to health insurers; is that right?

10 A Yes.

11 Q Are these restrictions designed to detect Premera's private
12 interests?

13 A I think they're designed to ensure that the proceeds of the
14 donation that they're making to the foundations are not used
15 against their interests.

16 Q Would it be fair to say not used against Premera's private
17 interests?

18 A Well, not necessarily. Healthcare insurers generally.

19 Q That also protects Premera's private interests; is that not
20 correct?

21 A Yes.

22 Q Again, I'd like you to refer to Exhibit P-84. And if at this
23 time you would look at page 29, please. Again, this is your
24 pre-filed direct testimony. At line one on that page, you
25 discuss the proposed trigger for a free vote, that is a vote

1 that is not subject to the voting trust, by the foundations
2 upon a change in control which includes a proposal to issue
3 or transfer more than 50.1 percent of New Premera's voting
4 securities; is that correct?

5 A My apologies. Can you state it one more time.

6 Q Surely. At that point in your pre-filed direct testimony,
7 you discuss the proposed trigger for a free vote, that is one
8 not subject to a voting - to the voting trust, a free vote by
9 the foundations upon a change in control which includes a
10 proposal to issue or transfer more than 50.1 percent of New
11 Premera's voting securities.

12 A Yes.

13 Q And if I understand correctly, Premera proposes - and tell me
14 if this is correct - Premera proposes that the foundations be
15 permitted to vote their shares freely where 50.1 percent of
16 the equity in New Premera will be involved. Is that an
17 accurate statement?

18 A In general, yes.

19 Q You criticize Blackstone's suggestion that the trigger or
20 threshold should be lowered to 20 percent; is that correct?

21 A Yes.

22 Q At the time I took your deposition, you told me that you had
23 no familiarity with the trigger or threshold for requiring
24 prior approval of the Commissioner for a change in control of
25 a health carrier. Is that still the case?

1 A Yes.

2 Q Would you be surprised that the trigger is 10 percent?

3 A I don't have any opinion on it.

4 Q Again, referring to your pre-filed direct testimony at
5 page 29. This time though I'd like you to direct your
6 attention to line 14.

7 A Okay.

8 Q There you discuss the proposal by Premera that the
9 foundations have a joint right to nominate one member to the
10 board until the earliest of: One, earliest of their
11 respective ownership falls below five percent; or two,
12 five years from the effective date of the voting trust and
13 divestiture agreement. Is that correct?

14 A Yes.

15 Q Now, Blackstone suggests that the time frame should be
16 extended; is that correct?

17 A Yes.

18 Q And you don't agree with the suggestion because it is not
19 consistent with your experience; is that right?

20 A Well, I don't agree with it because I think it would be
21 highly unusual to have such a guaranteed board seat last to
22 the extent that Blackstone suggests.

23 Q In fact, you state under the voting trust and divestiture
24 agreement that the highest percentage that either foundation
25 would own by the fifth anniversary would be in the low teens;

1 is that correct?

2 A Yes.

3 Q And when you say . . . And in fact, I think your exact
4 language in your pre-filed direct testimony is very low
5 teens. Does that mean 13 percent?

6 A Well, I don't know that it means an exact percent because I
7 don't know the allocation between Washington and Alaska.

8 Q So you're not suggesting that it would be 13 percent or
9 whatever that number would be for each foundation. It would
10 be in the aggregate; is that correct?

11 A No. I'm saying that by that point in time, the fifth year,
12 in the aggregate, they need to be down to 20 percent or
13 below. And as a result, depending again on how the shares
14 are divided up, my thinking is that probably the biggest is
15 going to be in the low teens, 15 or lower.

16 Q If you'd refer again to your pre-filed direct testimony, and
17 if you'd look at page 24, please. And I would ask you to
18 direct your attention to line 15. You state there that
19 Blackstone assumes that the only reason for imposing the
20 voting trust and divestiture agreement is the Blue Cross/Blue
21 Shield Association divestiture requirements; is that correct?

22 A That is my statement, yes.

23 Q Are you suggesting that Blackstone's assumption in this
24 respect is not reasonable?

25 A Well, I guess, because I disagree with the assumption, yes.

1 Q Are you aware of the basis for the assumption?

2 A I have no idea.

3 HAMJE: May I approach the witness please?

4 JUDGE FINKLE: Yes.

5 Q (BY MR. HAMJE) Mr. Steel, I've handed to you pages 13
6 through 14 of the Form A statement, of the Revised Form A,
7 which is Commissioner's Exhibit 2, which pertains to the
8 voting trust and divestiture agreement. I'd like you to read
9 to yourself those - that section that starts on page 13 and
10 it includes I believe four paragraphs onto page 14, please.

11 A (Witness complying.) Okay.

12 Q I'd like to read into the record just a portion of this. I'm
13 going to start on the second paragraph, if I could.

14 MR. MITCHELL: I would object. I don't believe
15 it's appropriate to read into the record a document that's
16 already there. And unless there's a question pending, I
17 don't think it's an appropriate use of cross-examination.

18 JUDGE FINKLE: This is a preface to a question, or
19 did --

20 HAMJE: It is. It is. I certainly want to ask
21 him about some of the language in this statement.

22 JUDGE FINKLE: Go ahead.

23 Q (BY MR. HAMJE) "Furthermore" - this is in the second
24 paragraph - "the provisions of the voting trust agreements
25 are necessary for New Premera to obtain and maintain a

1 license to use the Blue Cross/Blue Shield trademarks since
2 the Blue Cross/Blue Shield Association, BCBSA, imposes
3 certain restrictions on the ownership of the stock of its
4 licensees, collectively the ownership limits. Pursuant to
5 the ownership limits, among other restrictions, no
6 institutional investor may own more than 10 percent of the
7 voting interest in New Premera. No noninstitutional investor
8 may own more than five percent of the voting interest in New
9 Premera. And no person may own more than 20 percent of New
10 Premera's capital stock regardless of such person's voting
11 rights. Provisions which put into effect the ownership
12 limits are incorporated in the charter documents of New
13 Premera."

14 Did I read that paragraph accurately?

15 A Yes.

16 Q Now, would you agree with me that Premera - that the - this
17 statement puts forward the reason for the voting trust and
18 divestiture agreement is that it is necessary to comply with
19 the Blue Cross/Blue Shield requirements in connection with
20 holding its license?

21 A That certainly articulates that it is necessary, yes.

22 Q And when you look at that section, do you note that there is
23 any other reason other than the Blue Cross/Blue Shield
24 Association requirements that are mentioned for the use of
25 the voting trust and divestiture agreement?

1 MR. MITCHELL: Object to the question as failing
2 to specify whether the section in question is the paragraph
3 quoted or the entire four paragraphs that were earlier
4 referred to.

5 HAMJE: I would limit it just to the four
6 paragraphs of that section.

7 JUDGE FINKLE: Go ahead.

8 A Tell me the question one more time.

9 Q (BY MR. HAMJE) Yes. If you would just - limiting yourself
10 just to the four paragraphs of that section on those two
11 pages that you've read to yourself, is there any reason other
12 than the Blue Cross/Blue Shield Association requirements that
13 are mentioned in this provision for voting trust and
14 divestiture agreement to be included?

15 A I think it is silent at best as to whether there are or
16 aren't any other reasons.

17 Q Are you aware of any other section of the Form A application
18 that mentions a reason for the voting trust and divestiture
19 agreement other than that it is necessary for Premera to
20 retain its Blue Cross/Blue Shield Association license?

21 A Not by memory. I don't recall whether there is one.

22 Q Now, in your testimony today and in your pre-filed direct
23 testimony at page 24, you talk about investors being worried.
24 And in your pre-filed direct testimony, you talk about it in
25 terms of overhang. Do you recall that?

1 A Yes.

2 Q Please describe overhang in the context of an IPO.

3 A Well, it is the - maybe the most common situation where you
4 see it is where a company that is going public has been
5 funded by various venture investors and they hold very large
6 holdings of the company's privately-held stock. And when the
7 company goes public, there is a common recognition that the
8 venture investors may wish to monetize their holdings
9 sometime soon. So there is worry about, "Gee, how quickly
10 might that happen and what effect might it have on the
11 market?"

12 Generally there's some kind of an understanding, at
13 least verbal, with the underwriters as to what the intentions
14 of the venture funding - the venture investors are relative
15 to that.

16 The other place - the other aspect of it that you see
17 is in the spin-off situation, where the overhang - in
18 addition to worrying about selling activity, it has another
19 aspect, which is can this large concentration of shares that
20 is held by the parent company, you know, can it be used to
21 vote in a way that involves some agenda other than the best
22 interests of the newly public company.

23 Q Is this worry about overhang something that is based upon any
24 empirical data?

25 A I would say empirical data undoubtedly exists. I have not

1 reviewed any empirical data. This concept that I'm talking
2 about is just based on my experience having done 30 public
3 offerings.

4 Q What is a lock-up?

5 A Well, there are several different kinds of lock-ups. But
6 probably the one you're referring to in the context of an IPO
7 is an agreement that shares will not be traded for a certain
8 period of time after the IPO becomes effective so that the
9 market can kind of settle down.

10 Q Are lock - lock-ups used to address overhangs?

11 A Yes.

12 Q In this proposal, the foundations will not be permitted to
13 sell their stock for six months after the IPO. Is that your
14 understanding?

15 A Yes.

16 Q Isn't that a typical lock-up?

17 A Yes.

18 Q Does the voting trust and divestiture agreement prevent the
19 Washington foundation from selling its stock?

20 A Not after that point, no.

21 Q Doesn't it actually do just the opposite, establish a
22 schedule to sell its stock?

23 A Right. It addresses the concern I was talking about earlier,
24 about the markets being worried about domination by large
25 shareholder who may have a different agenda and wanting some

1 assurance that they're going to divest over time and wanting
2 some visibility into kind of a predictable schedule by which
3 that might happen.

4 Q Is it really necessary to impose a voting trust to deal with
5 an overhang?

6 A Well, I guess it depends on what you mean by necessary. I
7 view it as a relatively customary kind of a thing to do.

8 Q Do you recall . . . And I believe you were here yesterday.
9 Do you recall the discussion yesterday with Mr. Marquardt
10 regarding the duplicate foundation issues?

11 A I was here. Give me a little bit more on what the discussion
12 was.

13 Q Well, and it involves an Exhibit P-94 that was introduced. I
14 don't know if you've got that there, and I don't have an
15 extra copy. But let me just briefly say there were - with
16 respect to the duplicate foundation issues, as described by
17 Mr. Marquardt, he talked about two - actually three issues.
18 Two that I wanted to ask you about is, first of all, the five
19 percent minus one of shares being voted outside of the voting
20 trust and the aggregation of the two foundations under the
21 divestiture schedule. Do you recall those particular points
22 that Mr. Marquardt raised?

23 A Well, very generally, I recall the discussion.

24 Q In effect, isn't this treating two separate legal entities as
25 one entity?

1 A This being --

2 Q Being - requiring that the shares be held by both - five
3 percent be limited to shares being held by both outside of
4 the voting trust and the aggregation of the two foundations
5 under the divestiture schedule. Instead of being treated
6 separately, they're treated as one. And I'm asking you in
7 effect: Is it not the case that two separate legal entities
8 are being treated as one?

9 A From my understanding of the factual situation here, it
10 appears to me that BCBSA is treating them as one, yes.

11 Q But BCBSA is - is not a signatory to the voting trust and
12 divestiture agreement; is that correct?

13 A No. But my understanding is that that requirement to treat
14 them as one originates with BCBSA.

15 Q And that requirement is imposed through the proposal that
16 Premera has presented to the Commissioner for approval; is
17 that correct?

18 A Right. The Form A reflects what Premera believes is
19 necessary to hang onto what it views as one of its crown
20 jewel assets, the license.

21 Q Are you aware of any other conversion where this has been
22 done?

23 MR. MITCHELL: Object to the form of the question,
24 the undefined "this".

25 Q (BY MR. HAMJE) Are you aware of any other conversion where

1 two entities, separate legal entities, have been treated as
2 one in this context?

3 A Well, my understanding - and I don't - I don't know for sure
4 if this is accurate - but my understanding is that there
5 haven't been other BCBSA conversions that involved multiple
6 states.

7 Q So this is unprecedented; is that correct?

8 A Well, it's an issue of first impression. In other words, it
9 hasn't - there has been no cause to investigate it before.

10 Q Do you acknowledge that the effect of the many restrictions
11 imposed upon the Washington foundation with respect to the
12 stock it will receive will reduce the value of the stock?

13 A No, definitely not.

14 Q Would a rational investor pay the same for stock subject to
15 the arrangements set forth in the registration rights
16 agreement and the voting trust and divestiture agreement and
17 the transfer grant and loan agreement as - as compared to
18 what a rational investor would pay for fully unrestricted
19 stock?

20 MR. MITCHELL: Object to the form of the question.
21 The hypothetical rational investor would presumably be
22 purchasing from the foundation shareholders and would be
23 doing so free of any such restrictions.

24 HAMJE: That was not my question. Maybe I should
25 go ahead and rephrase the question.

1 JUDGE FINKLE: I think you need to clarify.

2 HAMJE: Sure.

3 Q (BY MR. HAMJE) Mr. Steel, you acknowledge that there are
4 stock restrictions that are the basis of arrangements between
5 New Premera and the foundation that are evidenced in the
6 registration rights agreement, the voting trust and
7 divestiture agreement and the transfer grant and loan
8 agreement; is that correct?

9 A Yes.

10 Q Then - and again, I'm dealing with just stock being purchased
11 subject to the arrangements made in these various agreements.
12 Would a rational investor pay the same for stock subject to
13 these arrangements as it would for fully unrestricted stock?

14 MR. MITCHELL: And I would object to the form of
15 the question in that there's no payment being made by the
16 foundations for the stock.

17 JUDGE FINKLE: Overruled.

18 A I think my answer would be it's kind of - you gotta drill
19 down a little bit more deeply. You know. The restriction
20 that most often results in a degradation of value is a
21 prohibition on your ability to transfer the shares. So for
22 example, privately-held stock, when a company goes public, if
23 it's still subject to securities law restrictions and needs
24 to be transferred subject to trading restrictions, will
25 generally have a lower value.

1 Here that's not the case as you, yourself, pointed out,
2 you know, that voting trust and divestiture agreement doesn't
3 prevent the foundations from making transfers other than
4 during their customary lock-up period.

5 So I think the question then boils down to: Well, what
6 about all these other voting and restrictions like that? And
7 I guess what I would - about the only comment I have on that
8 is I think that in situations like this, those kinds of
9 restrictions are ones that are customarily accepted by say a
10 parent company or others who may be in a position of a
11 dominant shareholder as sort of the price of admission in
12 order to achieve liquidity. You know, these are - these are
13 designed to enhance the value of the stock, not to degrade
14 it.

15 Q You compare these arrangements today, and in fact, you
16 compared them a couple of times, to those you have seen in
17 spin-off transactions; is that correct?

18 A Right.

19 Q In a spin-off, a portion of a company is sold sometimes to
20 employees of the company; is that right?

21 A Well, the type of spin-off I'm talking about is where you're
22 taking it public.

23 Q And this, of course, is not the case here. It's not a
24 spin-off at all, is it?

25 A No. I'm just analogizing to the situation - other situations

1 that bear common characteristics to this one, where you have
2 some - one or two dominant shareholders and the public is
3 buying a small portion of the company.

4 Q Do the restrictions on the stock protect the Blue Cross/Blue
5 Shield name and mark?

6 A I would imagine that is how Blue Cross/Blue Shield
7 Association would use it, yes.

8 Q How does it do it? How do these restrictions protect the
9 Blue Cross/Blue Shield name and mark?

10 A I don't know all of their thinking on it.

11 HAMJE: May I approach the witness, please?

12 JUDGE FINKLE: Yes.

13 Q (BY MR. HAMJE) I believe you already have what I'm looking
14 for up there - hopefully I gave it to you - a copy of New
15 Premera's proposed articles of incorporation. Do you have
16 them up there, the Article 2, board of directors?

17 A Yes.

18 Q I'd like you to take a look at them, if you would. And I'd
19 like you to take a look first at section 7 on page 12.

20 A Well, all I have is Article 2.

21 Q Oh, I'm sorry. In fact, I didn't give you the right one. So
22 I do need to approach you. What I've handed to you,
23 Mr. Steel, is a copy of Exhibit - I believe it is B-2 to the
24 Revised Form A, which is Commissioner's Exhibit 2, the
25 articles of incorporation of New Premera Corporation. I'm

1 sorry. No. It's B-1. I apologize. It is Exhibit B-1.

2 What I'd like you to do is go to page 12, please, and look at
3 section 7.

4 A So Mr. Hamje, I still only have 9 through 12. Is that what
5 you meant?

6 Q Yes. And if you look at section 7 on page 12, please. I
7 think I've gotten it straightened out now. Take your time.
8 Go ahead and review that section, please.

9 A (Witness complying.) Okay.

10 Q According to that section, would it be accurate to say that
11 the board of directors elects its own replacements?

12 A No.

13 Q Then what does that section do then, sir?

14 A Well, I presume you're talking about the first sentence in
15 general. And all that addresses is a situation where a
16 vacancy occurs on the board in between elections. And the
17 board has the ability to fill the vacancy.

18 Q That was my question. Is that correct? The board does fill
19 vacancies?

20 A Until the end of the term of the departed director, yes.

21 Q So with that limitation, it does - the board of directors
22 does select replacements to the board of directors; is that
23 correct?

24 MR. MITCHELL: I would object to the form of the
25 question. Mischaracterizes his testimony.

1 A It is correct that in that very narrow corner case, that they
2 select a replacement. But you gotta understand that that
3 doesn't mean that the directors vote themselves in, because
4 they don't. Shareholders do.

5 Q (BY MR. HAMJE) Well, if you could now look at section 5
6 please, which is on page 9. And if you'd focus your
7 attention . . . Well, what I would suggest you do is . . .
8 It's a long section. But I'm specifically interested in
9 section 5B 2, sub 2. If you could take a look at that and
10 read that to yourself.

11 A Okay.

12 Q Would you agree that that provision provides that only
13 holders of more than five percent of New Premera stock can
14 nominate directors?

15 A So Mr. Hamje, do you have the balance of the articles, what
16 comes before page 9?

17 Q No. For the purposes of my questioning, I would like you to
18 just limit yourself to that section, please.

19 MR. MITCHELL: I would object. If the section is
20 not complete in and of itself, I think the witness should be
21 given the whole document.

22 JUDGE FINKLE: Right. The question was about the
23 articles. If you'd want to say what that section says and
24 confine your question in that way, you certainly may.

25 HAMJE: That's what I'm doing.

1 Q (BY MR. HAMJE) I specifically would like you to answer the
2 question with respect to section B - I'm sorry - section
3 5B 2.

4 A I understand that. But what I'm saying is I'd like to see
5 how section 5 fits into the rest of the article.

6 JUDGE FINKLE: And he may see other sections
7 before he answers the question.

8 HAMJE: Then if I could go ahead and ask that we
9 can go ahead and provide a copy of Exhibit B-1 of the - of
10 Commissioner's 2 to - which is the Revised Form A. And I
11 will - if it can be obtained, I will go ahead and give it to
12 him. (Handing to witness.)

13 For the record, I've handed Mr. Steel a complete copy
14 of Exhibit B-1 to the Revised Form A, Commissioner's
15 Exhibit 2.

16 A All right. I'm ready.

17 Q (BY MR. HAMJE) What I'm asking you is when you look at
18 section 5B 2 on page 9, do you agree that it provides that
19 only holders of more than five percent of New Premera stock
20 can nominate directors?

21 A Yes.

22 Q Is it not correct though that the BCBS Association rules
23 prevent anyone other than an institutional investor from
24 meeting this test?

25 A I'm not sure what you mean by meeting this test.

1 Q Well, isn't it true that under the BCBS Association rules,
2 that only an institutional investor can have in excess of
3 five percent - hold in excess of five percent of the stock?

4 A Yes. I think that that - I mean I don't hold myself out as
5 an expert on the BCBS rules. But I think that is what is
6 referenced in little ii of this paragraph, where we're
7 talking about there must be a 13G filing rather than 13D
8 filing. That, in securities law parlance, generally means
9 that it's an institutional investor.

10 Q Now if you'll look at, on page 12, section 5D, as in David.

11 A Yes.

12 Q Would you agree that according to that section, that even if
13 there are shareholders that have - hold more than five
14 percent of New Premera's stock, that only one of them can
15 nominate a candidate at any time to the board of directors?

16 A Well, I mean they can submit the nominations. This addresses
17 the situation where several of them do submit the nomination
18 and then this deals with screening down to which one we're
19 going to present to the shareholders.

20 Q And only one of them then can be nominated as a candidate to
21 the board of directors, is that right, according to that
22 section?

23 A Yeah. I mean it's really without regard to the nominations
24 that are made by the foundations under F.

25 Q Would you concede that New Premera's board of . . . I'm

1 sorry. Would you agree that New Premera's board of directors
2 will largely, based upon these sections, be
3 self-perpetuating?

4 A No.

5 Q Why not?

6 A Well, for one thing, every election generally is going to
7 involve three or four directors, not the entire board. So
8 limiting it to one is not, you know, is not a small
9 percentage, if you had this kind of thing going on every
10 year, year after year.

11 Secondly, I think, you know, this is in line with what
12 the Securities and Exchange Commission has been proposing as,
13 you know, good corporate governance even under their - the
14 most advanced rules that they've been proposing to give
15 shareholders access. They're talking about giving holders of
16 five percent or more who've held their stock for two years
17 access. And then they have numerical limitations on how many
18 can be - can be elected at one point in time. And for
19 situations like this one, where there's a classified board of
20 directors, that number gets down to one because there's so
21 few people elected every year.

22 Q Do you know how many members are proposed for New Premera's
23 board of directors?

24 A I don't know the exact number. I think it's somewhere
25 between nine and 12 I think.

1 Q Are you aware of any other conversions where a similar
2 limitation as set forth in the three sections that you and I
3 went over just previously has been imposed in the board
4 member nominations process?

5 A Well, I think this whole concept of under what circumstances
6 are shareholders entitled to make nominations is a new thing,
7 you know, within the last year really. SEC rules have really
8 put a spotlight on it. And I think that that is what - I
9 don't know all of the thinking that went into the preparation
10 of these articles, but I would imagine that that was the
11 genesis for this - these kinds of provisions.

12 Q Mr. Steel, does that mean your answer is no to my question?

13 A Well, what I . . . What I was trying to point out was that
14 this is a new phenomenon so I don't know that it would have
15 been reflected in other Premera - other Blue Cross
16 conversions.

17 Q Are you aware of how many shareholders of stock in WellPoint,
18 WellChoice and Anthem, other than the foundations, hold more
19 than five percent of the stock of those companies?

20 A No.

21 HAMJE: Thank you, Mr. Steel. That's all I have.

22 MR. MADDEN: Good morning, Mr. Steel.

23 THE WITNESS: Good morning.

24 //

25 //

CROSS-EXAMINATION

BY MR. MADDEN:

Q Prior to joining your current firm, you were a partner first in the Riddell Williams firm and later in the merged entity Graham & James, Riddell, Williams; is that right?

A Yes.

Q And while you were a partner in the firm - if you'll indulge me, I'll call it the Riddell firm - was the Riddell firm counsel for Premera?

A I believe they did some work for Premera, yes.

Q To let us understand your testimony regarding the effect of the not-for-profit corporation act a little bit more, let me begin by asking you if it is correct, in your view, that under RCW 24.03.225, sub part 3, which I'm going to shorten up to 225 sub 3, that assets received and held by not-for-profit corporations with a charitable purpose are required to be distributed upon dissolution of the corporation to organizations with a substantially similar charitable purpose; is that right?

A Mostly. I don't agree with the wording that you chose to - where you said assets received and held by a corporation with a charitable purpose. I think that's what you said. And I think the wording in the statute is received and held subject to limitations requiring their use for - dot dot dot -

1 charitable uses or something like that.

2 Q Fair enough. This provision, 225 sub 3, has been in the
3 not-for-profit corporation act since it was adopted in 1967;
4 is that correct?

5 A Yes.

6 Q And the provision itself is consistent with common law
7 charitable trust principles regarding the distributions of
8 assets held subject to a charitable trust. Is that also
9 correct?

10 A Yeah. As I note in my report, you know, there is a - there
11 is a debate as to whether these provisions do or don't
12 supplant the common law concept. But in general, I think
13 this model act provision was meant to replicate the common
14 law principles, yes.

15 Q And as you indicated earlier, under RCW 24.03.230, the
16 Attorney General must review and approve the distribution of
17 assets by a not-for-profit corporation with a charitable
18 purpose. Is that also correct?

19 A Same distinction I made earlier and that is that it must
20 review and approve a distribution of assets by a
21 not-for-profit corporation that holds assets that are subject
22 to charitable use restrictions.

23 Q The authority that's granted to the Attorney General under
24 RCW 24.03.230 is the only statutory authority that the
25 Attorney General has with respect to not-for-profit

1 corporations. Is that fair?

2 A No.

3 Q Is there in RCW 24 - in RCW chapter 24.03, the not-for-profit
4 corporation act, any other reference to the authority of the
5 Attorney General?

6 A I believe there is a section in there that talks about the
7 Attorney General's ability to monitor and intervene in cases
8 where the Attorney General concludes that there are
9 ultra vires actions occurring.

10 Q With respect to the dissolution and distribution of assets,
11 is there any statutory authority in 24.03 other than the
12 authority granted by section 230?

13 A And other than the ultra vires section, which could apply to
14 distributions?

15 Q Yes.

16 A None other than what I'm aware of.

17 Q Do you have in front of you the exhibit book that contains
18 the Intervenor's exhibits, starting with I-1? I know
19 Mr. Mitchell asked you about one of those. If you don't have
20 it, I'll --

21 MR. MITCHELL: It would be the white notebook in
22 front of you, I think, Mr. Steel.

23 THE WITNESS: This one here?

24 MR. HAMJE: If I may approach the witness, I can
25 take one of those binders.

1 THE WITNESS: Otherwise you won't be able to see
2 the witness. Which one?

3 Q (BY MR. MADDEN) Could you turn to I-1. That's the letter
4 from Mr. Barlow and Mr. Milo to the Attorney General that's
5 dated May 30th, 2002.

6 A Yes.

7 Q And if I could direct your attention to page 3 of that letter
8 at the bottom, specifically the paragraph that's headed
9 "Government Approvals," where it says, "Various elements of
10 the proposed reorganization require review and/or approval by
11 different state officials, for example, corporate elements of
12 the proposed reorganization and, in particular, the
13 distribution of assets of the Washington nonprofit
14 corporations on dissolution, come under the provisions of
15 RCW 24.03 and RCW 24.06."

16 Let me ask you: Is there any other provision of 24.03
17 other than 225 sub 3 and 230 that could apply to this
18 transaction?

19 A The ultra vires authority.

20 Q So the Attorney General could conclude that the transaction
21 was ultra vires?

22 A If that was his - or her opinion, yes.

23 Q Has anyone suggested to you that that is a basis for review
24 by the Attorney General?

25 A I don't know.

1 Q And that's not an issue that Premera's asked you to look at,
2 is it?

3 A No.

4 Q Apparently they're not concerned about it.

5 MR. MITCHELL: Object to the question.

6 JUDGE FINKLE: Sustained.

7 A I can't read their minds.

8 JUDGE FINKLE: Excuse me.

9 A I think --

10 JUDGE FINKLE: I just . . . There's no question
11 before you.

12 A Okay.

13 Q (BY MR. MADDEN) Mr. Steel, I want to ask you about another
14 aspect of your supplemental report and pre-filed testimony.
15 And that is your reference to public benefit corporations
16 under RCW 24.03.490. Do you recall that portion of your
17 testimony?

18 A Yes.

19 Q Are you saying that only - that the only Washington
20 not-for-profit corporations that are subject to 225 sub 3 are
21 those that are identified as public benefit corporations
22 under 490?

23 A Well, 225 (3) doesn't depend on the corporation or what kind
24 of status it has. It depends on the assets.

25 Q So is the answer to my question no, it - the application of

1 225 sub 3 is not limited to public benefit corporations?

2 A That's correct.

3 Q And are you also saying then that the category of
4 corporations with a charitable purpose is not limited to
5 those corporations that would qualify as public benefit
6 corporations under 490?

7 A I'm sorry. I lost it there. Can you give it to me one more
8 time.

9 Q Are you also saying that the class of corporations subject to
10 225 sub 3 is not limited to those identified as public
11 benefit corporations under 490?

12 A I think that's the question I just answered.

13 Q Just want to make sure we're tracking. You say in your
14 pre-filed direct testimony at page 11, line 7 and 8, that
15 hospital care has been considered inherently charitable under
16 both common law and tax law; is that correct?

17 A Historically, yes.

18 Q Now, is it correct, to your understanding of the law, that
19 hospitals that are charitable in nature must ensure that all
20 of their assets are used for charitable purposes?

21 A Well, again, this comes down to the question of, you know,
22 what is the history of the organization, have the assets -
23 are all of the assets shown to be subject to charitable use
24 restrictions. So I mean, again, it is a factual question in
25 the case of a hospital as well.

1 Q So you're suggesting that in the case of a hospital, one
2 would have to look at the history and ascertain what, if any,
3 of the assets were received and held under charitable
4 restrictions?

5 A Yeah. I - the comment I'm making there is that I think
6 getting to that conclusion in the case of the hospital is a
7 little easier, given the different history of hospitals.

8 Q Well, do you stand by the general proposition that hospitals
9 have historically been considered charitable even though it
10 may be the case that the vast majority of the revenue of the
11 hospital is received from fees charged to patients?

12 A I think they evolved into that. But I do think that it is
13 still true that historically, they were viewed as charitable
14 organizations.

15 Q And is it . . . How about today? Is your conclusion
16 different? Or are you just reciting something that you
17 believe has changed?

18 A Well, I guess for what purpose are we attempting . . . I
19 mean I believe the comment that we're referring to in my
20 report has to do with why did the Washington State
21 Legislature draw the line at only including hospitals in the
22 nonprofit hospital conversion statute and why didn't they
23 include healthcare insurers. And the only point I was making
24 was that's a pretty logical place to draw the line, because
25 historically hospitals were considered charitable by their

1 nature, whereas healthcare insurers never had any margins
2 that were charitable in nature.

3 Q Yes. But at the time the Legislature developed the nonprofit
4 hospital conversion act, if I can call it that, it was the
5 case that hospitals predominantly received their revenues
6 from fees charged to patients; isn't that correct?

7 A I presume the Legislature took that into account.

8 Q But nevertheless, the Legislature indicated that hospitals
9 had to undergo this additional scrutiny under the legislation
10 that it adopted.

11 A Yeah. They decided to impose that additional scrutiny on
12 hospitals and decided not to impose it on healthcare
13 insurers.

14 Q Now let's leave aside the hospital conversion legislation for
15 a minute and return to common law and tax principles. Is it
16 not the case that a hospital, even a hospital with - a
17 hospital that is considered charitable, even though it may
18 receive the vast majority of its funds through patient fees,
19 is required to dedicate all of its assets to charitable
20 purposes?

21 A Are you talking about under the not-for-profit statute?

22 Q I'm talking about under the - under common law charitable
23 trust principles and tax law.

24 A Well, I'm not going to give you an opinion on tax law because
25 I'm not a tax expert. But the general rule that I

1 articulated earlier, namely you need to go into a
2 fact-intensive inquiry as to what is the history of the
3 organization and how it's operated and where did its assets
4 come from. All of that would need to be examined in order to
5 make some kind of a judgment.

6 Q Let's cut through all that and assume that the hospital has
7 been determined to be a charity. And my question is: Is it
8 not required to dedicate all of the assets to charitable
9 purposes?

10 A Well, designated as a charity by whom?

11 Q By itself. By the law. By the Attorney General. Take your
12 pick.

13 A Well, as appealing as that simplicity is . . . I mean I'd
14 like to be able to answer that question, but you need to -
15 you need to be a little more detailed in terms of what - for
16 what purpose. Because for example, the simple fact that an
17 organization might declare itself to be charitable in its
18 articles, if then followed by essentially no charitable
19 operations, you know, it doesn't carry the day. I mean it
20 isn't determinative of the question. That's why you need to
21 do a factually-intensive inquiry.

22 Q Let me ask you to indulge me in a small digression. Could
23 you look at Exhibit I-7 for me. Those are the original
24 articles of incorporation of the Medical Service Corporation
25 of Spokane County which you discussed with Mr. Mitchell this

1 morning.

2 A Yes.

3 Q Let me direct your attention to the opening recital of those
4 articles which states that, "The undersigned are desirous of
5 forming a corporation under authority conferred by Chapter
6 135 of the laws of 1895, also known as section 3863 of
7 Remmington's Compiled Statutes of Washington."

8 You know from your research and specifically from
9 reading the Swedish Hospital versus Department of Labor &
10 Industries case that you cite in your report that that is a
11 statute under which charitable corporations were formally
12 organized in Washington; isn't that correct?

13 A Yeah. That statute allowed charitable organizations to be
14 organized under it. But that wasn't the only kind of
15 corporation that could be organized under it.

16 Q And the others were educational, benevolent, things of that
17 nature; correct?

18 A I can't remember the exact listing, but it's broader than
19 charitable.

20 Q You've also said in your pre-filed direct testimony at
21 page 13 - so you can refer to it if you'd like - lines 11 to
22 23, and page 14, lines 1 and 2, that Premera Blue Cross
23 strikes you as an inherently charitable enterprise and
24 therefore - excuse me - let me say that again - an inherently
25 commercial enterprise --

1 JUDGE FINKLE: I thought that was a pretty good
2 bit of cross-examination.

3 MR. MADDEN: I'm not capable of that kind of
4 nonchalance, your Honor.

5 Q (BY MR. MADDEN) -- and therefore not charitable. My
6 question for you is: What legal authorities, if any, did you
7 rely on in this regard to assert the conclusion that Blue
8 Cross is inherently a commercial enterprise and not
9 charitable?

10 A Well, I don't - I think a number of resources. But from a
11 factual standpoint, the principal fact is that their business
12 consists, as I understand it, entirely of fee for service.
13 In other words, they provide insurance and subscribers pay
14 them for it. And they conduct business on the same basis as
15 other for-profit companies that are engaged in the same
16 business. And I think that that source of revenues is the
17 predominant, if not the exclusive, source of their assets.

18 And in those court cases that have gone into this
19 factual inquiry in other states who have looked at Blue Cross
20 organizations that have that pattern of conducting business,
21 every one of them has come out to the conclusion that this
22 Blue Cross entity is not a charity and its assets are not
23 subject to a charitable trust.

24 Q So court cases that speak to the question of whether Blue
25 Cross entities are commercial enterprises would be important

1 to your consideration?

2 A Court cases that speak to the charitable trust question.

3 Q Well, you're drawing the conclusion, are you not, that
4 because it seems to be an inherently commercial enterprise,
5 that it's not charitable?

6 A Well, I think that is the way I described it was I think that
7 is one of the central facts that is involved in the
8 charitable trust analysis.

9 Q Did you look at the Blue Shield of Texas versus Royal Drug
10 decision by the United States Supreme Court issued in 1979?

11 A No. I don't believe I did.

12 Q With respect to the not-for-profit hospital conversion
13 statute, you said that the Legislature had in front of it the
14 entire model act that was drafted by the National Association
15 of Attorneys General. Did I hear that correctly?

16 A In my report, I indicated that the Attorney General at the
17 time was a member of that group that put that model act
18 together. And I believe that that model act was what was in
19 front of the Legislature.

20 Q And you're making the assertion that our Legislature
21 consciously refrained from adopting the entire model act?

22 A Well, they had the model act in front of them. And I can
23 only believe that it was conscious.

24 Q So are you asserting that the entire model act was introduced
25 as a bill in the Legislature?

1 A No.

2 Q It would be a bit of a stretch then to say that the
3 Legislature consciously considered and rejected the entire
4 model act if the entire model act was never introduced.

5 A Well, whether it was introduced or not, you know,
6 legislatures are presumed to be aware of model acts. And
7 when they make decisions that go a different direction, they
8 are presumed, under interpretive case law that governs
9 statutory interpretation, to have made a decision.

10 Q That rule applies to model acts drafted by the Commission on
11 Uniform Laws; correct?

12 A No. I don't know that it's that narrow.

13 Q Mr. Steel, in connection with your opinion that it is not a
14 relevant inquiry here whether the foundation proposal
15 maximizes the value that would be received by the - by those
16 foundations . . . I guess I should ask: Is that your
17 opinion?

18 A Well, I - it may be relevant to something. I don't view it
19 as being relevant to Premera's legal obligations.

20 Q The foundations will, as you understand the proposal, receive
21 those assets, the stock, for charitable purposes; is that
22 correct?

23 A Yes.

24 Q Have you considered whether the assets that will be available
25 for charitable uses by the foundation, in particular the

1 amounts that may be distributed by those foundations, whether
2 that - those amounts would be sufficient to cover the costs
3 of any deliterious business practices that Premera might
4 adopt in order to satisfy profit expectations?

5 MR. MITCHELL: Object. It assumes facts not in
6 evidence.

7 JUDGE FINKLE: Overruled.

8 A In addition, I'm not sure I understand the question.

9 Q (BY MR. MADDEN) Well, if Premera, for example, decided to
10 give up a line of business that was focused more on poor
11 people or people living in rural areas, have you considered
12 in your analysis whether the assets of these charitable
13 foundations and the amounts that could be expected to be
14 distributed by those foundations would be sufficient to cover
15 the costs of such a business practice?

16 A I guess I'm having trouble drawing a connection between the
17 assets in the hands of foundations and why they would be
18 trying to cover costs of New Premera's business practice.

19 Q This is another irrelevant inquiry?

20 A No. I just don't understand your question.

21 Q Well, let me withdraw it in the interests of time.

22 MR. MADDEN: Thank you. I have no further
23 questions.

24 MS. McCULLOUGH: Judge Finkle, I have a couple of
25 questions.

1 JUDGE FINKLE: Oh, I'm sorry. About how long do
2 we have on your questions and on redirect so that - decide
3 about the lunch here? About how long on Alaska? And then
4 I'll hear from Premera and just decide about the lunch break.

5 MS. McCULLOUGH: Five minutes.

6 MR. MITCHELL: I would guess 15.

7 JUDGE FINKLE: Let's eat.

8 (Lunch recess.)

9 JUDGE FINKLE: Ready to resume when you are.

10 MS. McCULLOUGH: Good afternoon, Mr. Steel.

11 THE WITNESS: Good afternoon.

12 MS. McCULLOUGH: I'm Amy McCullough, and I'm going
13 to be asking you some questions on behalf of the Alaska
14 Intervenors.

15
16 CROSS-EXAMINATION

17
18 BY MS. McCULLOUGH:

19 Q First, it's your testimony that the voting trust agreement
20 restriction should continue even if the Blue Cross marks are
21 lost because it will help reduce public investors' fears of
22 business domination; is that correct?

23 A Basically, yes.

24 Q And what does business domination mean?

25 A Well, the ability to vote the shares however the foundations

1 might like.

2 Q So you mean by that that the foundations would dominate
3 Premera's business?

4 A Well, to the extent that they can dominate the voting on
5 various issues, for example, election of board members and
6 things of that nature.

7 Q And subject to the divestiture schedule, the foundations will
8 hold less than 50 percent of the outstanding shares in
9 Premera following three years after the conversion; is that
10 right?

11 A Yes.

12 Q So if they - if three years following the conversion, they no
13 longer hold 50 percent of the shares, the concerns regarding
14 business domination would disappear, wouldn't they?

15 A Well, holdings of less than 50 percent in a public company
16 can be extremely meaningful from a voting angle.

17 Q They'd be meaningful, but they wouldn't dominate; is that
18 right?

19 A Well, they could be.

20 Q In what context?

21 A Well, typically not all public holders vote. Certainly
22 frequently something less than 50 percent actually
23 constitutes a majority.

24 Q The foundations will be long-term shareholders; is that
25 right?

1 A They may be. But I don't - I wouldn't think that would be
2 their primary objective. I would think their main objective
3 would be to monetize their holdings of stock as quickly as
4 they can at the highest price they can get and move on to
5 grant making.

6 Q Okay. So would it be fair to say they have an interest in
7 protecting their financial interests?

8 A I would hope so.

9 Q And they have an interest in optimizing their share value; is
10 that right?

11 A I would hope so.

12 Q So if that's the case, they wouldn't have any incentive to
13 act in any way that would impair the value of those shares;
14 is that right?

15 A That - that may be true. But I'm not sure that the public
16 market would be comforted if you didn't have some
17 restrictions on it.

18 Q Okay. Thank you. The charitable foundations that Premera
19 has proposed to set up or to establish as a result of this
20 conversion will be 501(c)(4) foundations; is that right?

21 A I believe that is right. Yes.

22 Q And Premera is a 501(c)(4); is that right?

23 A No.

24 Q It's not?

25 A No.

1 MS. McCULLOUGH: Okay. Thank you. No further
2 questions.

3
4 REDIRECT EXAMINATION

5
6 BY MR. MITCHELL:

7 Q Good afternoon, Mr. Steel. At the beginning of his
8 cross-examination, Mr. Madden, who represents the Washington
9 State Hospital Association, asked you about your predecessor
10 affiliation with the Riddell Williams firm. Do you remember
11 that question?

12 A Yes.

13 Q And I believe you testified in response to Mr. Madden's
14 question that the Riddell firm represented Premera in some
15 matters; is that correct?

16 A Yes.

17 Q Did you personally have any involvement with Premera or
18 Premera matters when you were at the Riddell firm or
19 otherwise?

20 A No.

21 Q At the time that you were at the Riddell firm, did the
22 Riddell firm represent the Washington State Hospital
23 Association?

24 A I believe they did.

25 Q Did the Riddell firm also represent hospitals in the state of

1 Washington?

2 A I don't know the answer to that. I wasn't part of that
3 practice area.

4 Q Sure. I wonder if I might direct your attention to
5 Exhibit I-1, which I hope is still in the binder in front of
6 you.

7 A Yes.

8 Q Is that the letter to Attorney General Gregoire?

9 A Yes.

10 Q My first question to you, Mr. Steel is this: Is the letter
11 which is Exhibit I-1 a notice the nature that is contemplated
12 by and required by RCW 24.03.230?

13 A I don't believe it is, no.

14 Q And why do you say that?

15 A Well, the - the two principal hallmarks in my mind are that
16 if it were me writing this letter on behalf of Premera, I
17 would have recited that it is a notice pursuant to 230. In
18 other words, I would have explicitly indicated that that was
19 the purpose of it.

20 And secondly, I would have indicated on here that it
21 was given by either registered or certified mail, as required
22 by 230. And that isn't on here either.

23 Q Does the letter which is Exhibit I-1 state that Premera is
24 charitable or has assets subject to a charitable trust or
25 assets subject to RCW 24.03.225 sub 3?

1 A May I take a moment and read it?

2 Q Please.

3 A No. There's no mention of that.

4 Q Is there language in the letter that, in fact, is
5 inconsistent with such an interpretation? If it would assist
6 you, Mr. Steel, I'd like you to focus on page 2, the
7 paragraph captioned "Health Plan Conversions National."

8 A Answer to the question is yes. There is language here to the
9 effect that Premera and its predecessor companies were not
10 established or operated as charitable institutions.

11 Q Does the letter which is Exhibit I-1 request the consent, the
12 permission or the authorization from the Attorney General for
13 the transactions discussed in it?

14 A No.

15 Q Mr. Steel, based upon your experience as a corporate lawyer,
16 is there any reason to send such a letter other than to
17 provide notice to the Attorney General under RCW 24.03.230?

18 A Yes. As I indicated earlier, the principal thing that is
19 going on here is that Premera is making distributions of
20 assets to the foundations in accordance with its articles.
21 And any time you've got articles limitations involved, the
22 potential for the Attorney General to raise an ultra vires
23 question is there. So I think it's prudent to notify the
24 Attorney General if - you know, just in case that issue might
25 be raised.

1 Maybe equally important, the history in the other
2 states where there have been conversions attempted is that
3 there have been allegations of charitable trusts made. And I
4 think even though Premera might have believed completely that
5 there was no charitable trust here, I think you'd rather find
6 out about the Attorney General's beliefs on that question
7 earlier rather than later. So I think it was just a matter
8 of prudence to notify the Attorney General.

9 Q Would you recommend to a nonprofit client of yours,
10 Mr. Steel, that had no charitable assets that it provide
11 notice to the Attorney General of a transaction of this
12 magnitude and nature?

13 A Yes.

14 Q Would it surprise you to learn, Mr. Steel, that substantially
15 similar letters went to Governor Locke and the Governor of
16 Alaska?

17 A No.

18 Q I want to talk to you about the restrictions on stock. That
19 was the subject of some questioning by Mr. Hamje, I believe.
20 First question is this: Does an entity in the position of
21 the foundations in this case need to have a registration
22 rights requirement or does it benefit from having one?

23 A Well, it certainly benefits because these foundations not
24 only will hold a very large percentage of stock, but in
25 addition, they have the ability to designate directors that

1 are going to be members of the New Premera board. And those
2 facts give the foundations what is known as affiliate status
3 under securities laws. And affiliates are subject to ongoing
4 limitations on their ability to sell stock into the open
5 market. And the only way to exceed those volume limitations
6 is to have registration rights.

7 Registration rights agreements are common in this kind
8 of a situation and are of significant value to the large
9 shareholder for two reasons: One, as I mentioned, it frees
10 the shareholder up from the volume limitations. But more
11 importantly, registration frequently will be handled - the
12 sale of shares, any registration frequently will be handled
13 through an underwriter, who will place the stock in a way
14 that supports the price much more effectively than can be
15 done through random selling on the open market.

16 Q Is it your understanding, Mr. Steel, that under the terms of
17 Premera's proposal, a hundred percent of the stock in New
18 Premera would be transferred free of any restrictions or that
19 the hundred percent of stock that would be transferred would
20 come with some restrictions? To the foundations I should
21 say.

22 A Well, I think it comes with both benefits and burdens. In
23 other words, there's a mix of things that the foundations
24 must do relative to the stock. And then in addition, there's
25 things like registration rights, for example, that are more

1 in the nature of a benefit.

2 Q Do the restrictions upon the foundations with respect to the
3 stock that they are given here follow the transfer of that
4 stock to a buyer in the market?

5 A No.

6 Q Is there any reason to believe, if that is the case, that a
7 buyer would be willing to pay less for the stock because it
8 had been restricted before the buyer got it?

9 A No.

10 Q Mr. Hamje asked you if you were aware of the rationale of the
11 Blue Cross/Blue Shield Association for restrictions that are
12 required as a condition of maintaining a license. And I
13 believe you told him that you were not familiar with the
14 BCBSA's reasoning. Do you recall that testimony?

15 A Yes.

16 Q Regardless of the BCBSA's thinking, do you have a view,
17 Mr. Steel, as to whether the restrictions imposed by the
18 BCBSA are important to Premera and the foundations?

19 A Whether the restrictions are important to Premera?

20 Q Maybe I should ask the question differently. Is it important
21 to Premera and the foundations that the restrictions,
22 whatever their rationale, be followed or abided by?

23 A Yes, for the reasons that I indicated earlier. In other
24 words, I think both Premera and the foundations have an
25 interest in, one, optimizing the price in the IPO and,

1 thereafter, in having the market view the gradual selling
2 process that is going to occur as predictable, ordinary
3 course kind of activity that does not destabilize the market.

4 Q And is it important to Premera and to its subscribers that
5 the Blue marks be preserved?

6 A Well, my . . . You know, I can't . . . I've listened to the
7 testimony on that. It certainly sounds to me, listening to
8 Mr. Barlow and Mr. Marquardt, that it's essential.

9 Q Mr. Hamje asked you a series of questions about a document,
10 an excerpt of which he distributed, captioned "Voting Trust
11 and Divestiture Agreement." Do you have that before you?

12 A Yes.

13 Q Would you please focus your attention on the last five lines
14 of the - or six lines of the first paragraph under that
15 heading. Mr. Steel, give me an indication when you've had a
16 chance to review that, please.

17 A This is in the first paragraph right under "Voting Trust and
18 Divestiture"?

19 Q Exactly, sir.

20 A Okay.

21 Q Is there language in that first paragraph, Mr. Steel, that
22 suggests reasons to have a voting trust agreement?

23 A Well, if there is, it's not jumping out at me. I'm sorry.

24 Q Is it a potential rationale for a voting trust agreement to
25 provide for an orderly divestiture of the stock held by the

1 foundations?

2 A Well, the two are related to one another. In other words,
3 the way the market views a large shareholder, one of their
4 principal concerns is that potential that the large
5 shareholder will somehow dominate and have a different
6 agenda, as I've discussed earlier. And the - one of the
7 functions of a divestiture agreement is to, you know, give
8 some comfort to the market that there is a plan for
9 eliminating that dominance.

10 Q Even in the absence of an articulated rationale in this
11 document for the voting trust agreement independent of the
12 Blue Cross Association - would you assume that for a moment
13 for me - is it your view --

14 A What am I assuming?

15 Q That there is no other stated rationale for an agreement
16 other than Blue Cross requirements.

17 A Okay.

18 Q Do you believe that there are good and sufficient reasons to
19 have a voting trust agreement, including specifically after a
20 loss of the Blue Shield mark, Blue Cross mark?

21 A Yes, definitely.

22 Q Could you turn to page 29 of your pre-filed direct testimony.

23 A All right.

24 Q That is, for the record, Exhibit P-84. Mr. Hamje asked you
25 some questions about the paragraphs headed "Change of Control

1 and Foundation Nominees Premera Board." Do you see that?

2 A Yes.

3 Q When you analyzed these particular provisions, Mr. Steel, did
4 you have an understanding as to whether or not the provisions
5 that had been set forth in Premera's Amended Form A were
6 required by the BCBSA?

7 A I may have known that at one point. I don't recall anymore
8 whether they are or not.

9 Q If you were advised that the BCBSA insisted upon a
10 50.1 percent threshold for free voting on a change in
11 control, and that the BCBSA insisted upon a maximum term of
12 the foundation nominees to the Premera board of the lesser of
13 five years or five percent stock ownership, would those
14 provide additional grounds for the provisions, additional
15 beyond those stated in your direct testimony here?

16 A Given the importance of retaining the BCBSA license, yes.

17 Q Can you turn over a page now to page 30. Do you see the
18 heading there "Director Independence"?

19 A Yes.

20 Q Mr. Hamje asked you some questions about this provision. And
21 I recall that with the assistance of Mr. Hamje's calculator,
22 you were able to determine the import of a two percent
23 requirement on an assumed revenue base of \$2.8 billion. Do
24 you remember that?

25 A Yes.

1 Q Are there companies traded on the New York Stock Exchange
2 with gross revenues in excess of \$2.8 billion?

3 A Oh, certainly.

4 Q Is the independence test that has been established by this
5 exchange different for such companies than that which has
6 been proposed by Premera?

7 A No.

8 Q I want to focus your attention, if I might, Mr. Steel, upon
9 another document which Mr. Hamje was kind enough to give you,
10 the bylaws of New Premera. It starts on Article 2, board of
11 directors.

12 A Okay.

13 Q You observed in your direct testimony, Mr. Steel, that the
14 test set forth in section 4F on page 4 of this document is
15 consistent with the independence rules of the New York Stock
16 Exchange; is that right?

17 A Yes.

18 Q Is it your understanding, Mr. Steel, that the test set forth
19 in section 4 sub F is more stringent than the New York Stock
20 Exchange test?

21 A Yes.

22 Q And how is it more stringent?

23 A The - the New York Stock Exchange test is the test set forth
24 in A, in other words what percentage of Premera's
25 consolidated gross revenues is involved.

1 Q Is the test in subparagraph B of that clause found in the
2 New York Stock Exchange test?

3 A I don't believe it is.

4 Q And does the test set forth in part B have the impact of
5 further narrowing the definition of independence relative to
6 the New York Stock Exchange test?

7 A Yes. These - these are alternative tests, either one of
8 which can disqualify someone from independence.

9 Q You testified in response to Mr. Hamje's question, Mr. Steel,
10 that Premera could agree, if it wished, to transfer the fair
11 market value of its assets to the foundations. Do you recall
12 that?

13 A Yes.

14 Q Would such an agreement, if it existed ordinarily, be
15 presumed or inferred from a letter written 13 months after
16 the application? Or would you expect to have something more
17 formal?

18 A Well, in my mind, agreement means there's more than one party
19 writing a letter. Maybe that's the lawyer way of looking at
20 things. But to me, agreement means that there's been a
21 meeting of the minds on something.

22 Q Take a glance at Exhibit S-86. Is that still before you?

23 A What does it look like?

24 Q Fax cover sheet.

25 A Yes.

1 Q Would you read the heading - the subject line of the letter
2 aloud please, Mr. Steel.

3 A Of the letter itself?

4 Q The letter itself.

5 A "Comments slash corrections regarding the October 3, 2003
6 draft OIC consultant reports."

7 Q There was a question to you about the protection of the
8 interests of New Premera through limits upon the lobbying
9 activities that could be carried on by the foundations. Do
10 you recall that testimony, Mr. Steel?

11 A Yes.

12 Q Would the protection of New Premera's interests to such
13 limitations also tend to protect the value of New Premera's
14 stock for the benefit of its shareholders, including the
15 foundations?

16 A Yes.

17 MR. MITCHELL: Nothing further. Thank you.

18 MR. HAMJE: No questions.

19 MS. McCULLOUGH: No questions.

20 JUDGE FINKLE: Thank you. Please step down.

21 MR. MITCHELL: Your Honor, Mr. Steel is the last
22 of our witnesses. We do have one housekeeping item that came
23 to our attention as we were going through the exhibit list.
24 We would like to offer Exhibits P-30 through P-34, which we
25 inadvertently neglected to do during the testimony of

1 Dr. McCarthy.

2 MR. HAMJE: We have no objection to P-30. We have
3 no objection to P-31. By way of explanation - forgive us for
4 taking this time - as you may recall, Mr. Ellis was lead
5 counsel with respect to Dr. McCarthy's testimony. And so he
6 is, I'm sure, very familiar with these exhibits. We are not.
7 And so we need to take a little bit of time.

8 JUDGE FINKLE: That's fine. Take your time.

9 MS. HAMBURGER: Your Honor, can I suggest that
10 perhaps when Mr. Ellis returns, we deal with this
11 housekeeping issue? But frankly, we object because we don't
12 know how these documents are relevant. We'd have to go back
13 and see. I don't think they were referenced in the
14 testimony. But I don't know for sure. I'd have to go back
15 and look at that testimony.

16 JUDGE FINKLE: How about resting subject to ruling
17 on admissibility?

18 MR. MITCHELL: Sure.

19 MR. HAMJE: Thank you. That would be fine.

20 MS. deLEON: Your Honor, before the OIC calls its
21 first witness, I do have a clarification regarding your
22 ruling regarding the deposition excerpts that you admitted
23 into the record. As we were going through the exhibits that
24 Mr. Mitchell gave us a laundry list of this morning, we found
25 that not only does this list include excerpts from

1 depositions, but also a lot of exhibits to the depositions.
2 And two of the designated exhibits weren't part of the
3 depositions at all. And I wanted to clarify with you that
4 you, in fact, wanted to have all those exhibits admitted as
5 well as the excerpts of the depositions.

6 JUDGE FINKLE: What two were not deposition
7 excerpts, or deposition exhibits I should say?

8 MS. deLEON: Exhibit P-149 and 150. We couldn't
9 find that they were related to a deposition.

10 JUDGE FINKLE: Comment on those?

11 MR. MITCHELL: I need to - I need to check the
12 record. Can you give me a moment, please?

13 JUDGE FINKLE: Yes.

14 MR. MITCHELL: Your Honor, Ms. deLeon is correct.
15 The documents that are exhibits P-149 and 150 were not
16 deposition exhibits. The reason for that - the only reason
17 for that is that they were withheld by the OIC Staff under a
18 claim of privilege, which you ruled was not well taken, so
19 they were provided to us after the deposition was taken.

20 JUDGE FINKLE: But they're not freestanding? I
21 mean what's the basis of admission? The purported basis was
22 impeachment or substantive evidence relating to the testimony
23 - sworn testimony of particular witnesses. And I didn't
24 review in detail I've gotta say the excerpts that were
25 proposed and took your representation as being that.

1 MR. MITCHELL: It is certainly the case, your
2 Honor, that because these documents were not available to us,
3 they were not discussed in the depositions. They do,
4 however, relate to a string of communications between
5 Mr. Cantilo, who was the deponent, and Mr. Fallis, many of
6 which are specifically addressed in the deposition. And they
7 were included here to make that exchange more complete than
8 it otherwise would have been. But Ms. DeLeon is certainly
9 correct. These are not deposition exhibits.

10 JUDGE FINKLE: The - those will not be admitted as
11 part of this grouping. That's without prejudice to offering
12 at the time of Mr. Cantilo's testimony or otherwise.

13 MS. deLEON: Thank you.

14 MR. MITCHELL: Very well, your Honor.

15 JUDGE FINKLE: What were those numbers? I'm
16 sorry.

17 MR. MITCHELL: 149 and 150, your Honor.

18 MS. deLEON: Your Honor, the OIC Staff would like
19 to call Jonathan Koplovitz as its first witness.

20 JUDGE FINKLE: Please raise your right hand.

21
22 JONATHAN KOPLOVITZ, having been first duly sworn by the
 Judge, testified as follows:

23
24 MR. MITCHELL: Excuse me, counsel. Your Honor,
25 can I remove the notebooks up there? I think we're building

1 a fence inadvertently.

2

3 DIRECT EXAMINATION

4

5 BY MS. deLEON:

6 Q Mr. Koplovitz, could you state your full name and spell it
7 for the record.

8 A Jonathan Koplovitz. J-o-n-a-t-h-a-n, K-o-p-l-o-v-i-t-z.

9 Q And where do you currently work?

10 A I work at the Blackstone Group.

11 Q Could you please summarize your educational background.

12 A Yes. I have a BA in economics from the University of
13 Pennsylvania. I also have an MBA in finance from the Wharton
14 School, where I graduated as a Palmer Scholar.

15 Q Could you please summarize your experience, your working
16 experience.

17 A Sure. I have 14 years of experience working in investment
18 banking, working on financing transactions, merger
19 transactions and other types of corporate advisory
20 transactions. I currently am a managing director at the
21 Blackstone Group, where I've worked since 1996. At
22 Blackstone, I work in the M & A/corporate advisory group.
23 And I specialize in providing advisory services to companies
24 in the financial services and insurance sector. Before
25 Blackstone, I worked at Wolfensohn and Co., a corporate

1 advisory boutique. And before that, I was at Bear Stearns,
2 where I worked in the corporate finance department.

3 JUDGE FINKLE: Excuse me. If you could either
4 move the microphone away from you or sit back a little bit.
5 Your testimony is important but . . .

6 THE WITNESS: Is that good?

7 JUDGE FINKLE: That's much better.

8 Q (BY MS. deLEON) What experience do you have on working on
9 demutualization or conversion transactions?

10 A I have a lot of experience working on demutualization and
11 conversions in both the life and health and also actually the
12 P & C areas of insurance. I have worked on the
13 demutualizations or conversions of MetLife, John Hancock,
14 Prudential, Principal Financial Group, Phoenix Home Life,
15 CareFirst. And also, I am currently working on the sponsored
16 conversion of Security Mutual Life. And typically on these
17 assignments, we have worked with - representing the state.
18 And we have worked for several states in addition to the
19 State of Washington. We've worked for the State of New York.
20 We've worked for the State of Maryland. We've worked for the
21 State of Iowa. We've worked for the State of New Hampshire.
22 And we've worked for the State of Pennsylvania. So we have
23 advised several states on demutualization and conversion
24 transactions.

25 Q Did you prepare pre-filed direct and pre-filed responsive

1 testimony for this proceeding?

2 A Yes, I did.

3 Q And did you also assist in the preparation and submission of
4 an initial report on valuation and fairness dated October 27,
5 2003?

6 A Yes, I did.

7 Q Did you also assist in the preparation of a supplemental
8 report, a review of G-10, an equity incentive plan, dated
9 November 24th of 2003?

10 A Yes.

11 Q And did you also assist in the preparation and submission of
12 a supplemental report on the valuation and fairness dated
13 February 27th, 2004?

14 A Yes.

15 Q And two reports on the allocation between Washington and
16 Alaska dated August 1st, 2003 and March 30th, 2004?

17 A Yes.

18 Q Were these reports incorporated by reference in your
19 pre-filed direct testimony?

20 A Yes.

21 Q And did you also attach to your pre-filed direct testimony a
22 copy of your curriculum vitae?

23 A Yes.

24 Q Mr. Koplovitz, do you adopt all of your pre-filed direct and
25 responsive testimony in this matter?

1 A I do.

2 MS. deLEON: Your Honor, with Mr. Koplovitz's
3 adoption of his testimony previously filed and served in this
4 matter, we would move for the admission of Exhibits S-1, S-2,
5 S-3, S-4, S-5 and S-6 as well as Exhibits S-49 and 50.

6 MR. MITCHELL: No objection.

7 MS. McCULLOUGH: No objection.

8 JUDGE FINKLE: Admitted.

9 MS. deLEON: Thank you.

10 Q (BY MS. deLEON) Mr. Koplovitz, what was the scope of your
11 assignment?

12 A We were basically asked at the outset to do two things. One
13 was to provide a valuation of Premera. The second was to
14 opine on the overall fairness of the transaction. And our
15 mandate changed a little bit as we went through the process.
16 It was determined, you know, through the course of the
17 process at some point - and I can't remember the exact date -
18 that we shouldn't do an independent valuation of Premera;
19 that a properly marketed IPO could satisfy the fair market
20 value test that we need to satisfy. And so our mandate was
21 changed a little bit from doing an independent valuation of
22 Premera to ensuring that the IPO was properly conducted. And
23 by that we would typically do something called an IPO
24 procedures opinion.

25 The second part of our mandate was to look at the

1 overall fairness of the transaction. And I think here we
2 looked at a few things. First of all, we looked at the
3 business case for conversion; did Premera make a good case
4 for a conversion. And also we thought about what are some of
5 the risks and potential negatives and issues associated with
6 converting. So we thought about the business case and also
7 thought about risks and issues associated with converting.

8 The second thing that went into our fairness
9 determination was: Did the foundation receive fair value at
10 the time of the closing of the conversion? So what was the
11 fair value of Premera transferred to the foundation at the
12 time of the closing?

13 And I think there are really three things that went
14 into this determination. First is the IPO. And I think as I
15 said, we determined that a properly marketed IPO could result
16 in fair value. But I think there's a little bit more.

17 The second point is dilution. At the IPO or right
18 before the IPO, the foundation owns a hundred percent of the
19 stock. And if there is significant dilution to the
20 foundation as a result of the IPO, that could influence our
21 ability to determine if the fair market value was given to
22 the foundation, if they are significantly diluted by the IPO.

23 And then the third point is whether or not the stock
24 had any restrictions or lacked rights or basically had
25 provisions that, you know, relative to other conversions,

1 would make that stock not have a fair value. And I think
2 those are the three areas that we looked at.

3 I will be testifying as to the business case and I will
4 also be talking about the dilution and the IPO procedures
5 part of it. Martin Alderson Smith, my colleague, will be
6 testifying about the restrictions and the lack - and the
7 rights associated with the stock and how that impacts the
8 fairness determination.

9 Q Thank you. Could you please describe briefly the steps that
10 you took when you prepared your initial report on valuation
11 and fairness.

12 A The October 2003 report?

13 Q Yes.

14 A Sure. We were retained on this assignment in, I believe,
15 November of 2002. And we basically did significant due
16 diligence on the business, the operations and the financial
17 position of the company. We reviewed historical financial
18 statements. We reviewed projections. We had several
19 meetings with the management team of the company. We met
20 with Goldman Sachs, the company's financial advisors. And we
21 reviewed lots and lots of documents. So we really did a very
22 thorough due diligence. And we had meetings with the other
23 consultants as well on our team and meetings with the Alaskan
24 consultants on certain occasions.

25 And basically based on all that work, that led to the

1 preparation of our reports in October 2003.

2 Q Now, you did a supplemental report which you filed in
3 February of 2004. What did Blackstone do to prepare the
4 supplemental report?

5 A Well, in between the time of our October report and the time
6 of our supplemental report, we had several discussions with
7 the company on the terms of the transaction. We had raised
8 several issues in our October report and we had several
9 meetings with the company, the company's advisors, the State
10 of Alaska, Alaska's advisors, and the other advisors from
11 Washington to discuss these issues and to try to narrow down
12 these issues. And we met several times in December, January,
13 before the Revised Form A was filed in February.

14 And then based on that and also based on refreshing our
15 diligence - we did refresh our diligence; we got some updated
16 numbers from the company - we published our report in
17 February - end of February.

18 Q Okay. Before we get into the specifics of the business case,
19 could you please tell us how this conversion has differed
20 from other conversions that you've worked on previously.

21 A Well, it's been similar in a lot of ways. I think one way
22 where it's been a little bit different is in certain of the
23 other conversions that we've worked on, when companies have
24 said they needed capital, they have said, you know, "Here are
25 the projects that we want to do and here are the capital

1 associated with these projects or these areas and here are
2 the sources of capital available to us. Okay. And then
3 look, the sources don't equal the uses and this is why we
4 need to convert, because we need this much capital."

5 I think here it was done a little bit differently. I
6 think, you know, the amount of capital has been thrown out
7 from the very beginning, this hundred . . . Well, originally
8 it was 100 to 150 million. Now the company's saying 150
9 million. But the uses of the capital have never really been
10 developed. And I think in the hearing testimony of the last
11 week, we've heard a lot of things that they might spend the
12 capital on. But we've never gotten a plan that says, "Look,
13 we need 150 million of capital for these initiatives and if
14 we don't get the capital, we're not going to be able to do
15 these initiatives."

16 So I think it's a little bit different in that way,
17 that they've kind of started with the number and now they're
18 trying to figure out where to spend it.

19 Q Did you analyze Premera's need for capital? And if so, what
20 conclusions have you drawn?

21 A We did analyze the need for capital. And I believe our - one
22 conclusion is that it's not an absolute necessity for the
23 company to convert and access the capital markets at this
24 time. I think the management team has made that statement
25 several times through our diligence efforts, that it's not an

1 absolute necessity. The company is growing, projected growth
2 of 15 percent earnings, increasing RBC throughout, you know,
3 the projection period. The company is forecasting 20 to
4 30 million dollars of capital spending on new projects per
5 year throughout the projection period.

6 The company - since we started working on this, you
7 know, well over a year ago, the company's RBC has actually
8 gone up quite a bit. When we started, it was around 400.
9 Now it's over 430. And if you take into account the money
10 they've actually spent on this conversion, if they hadn't
11 spent the \$30 million on this conversion, they'd probably be
12 above 450. So the company is in, you know, a fairly good
13 position and it has - it's not an absolute necessity that it
14 convert.

15 Q So in your view, is Premera currently capital constrained?

16 A I would say no. In my experience, companies that are capital
17 constrained are not looking outward and thinking about
18 strategic initiatives. They're looking inward and they're
19 really trying to figure out how to fix the problems. Premera
20 is doing a lot. They just spent a lot of money on this
21 dimensions program, \$125 million. It enabled them to get the
22 Microsoft account, it's state of the art, platform. They are
23 expanding into Arizona, which is going to use up, you know, a
24 decent amount of capital and it's not going to produce
25 earnings for several years, it's our understanding, before

1 they start producing earnings in Arizona. They're pursuing
2 this conversion, which obviously is eating capital. So they
3 - they are thinking strategically. They're thinking outward.

4 And again, they've never given us a list of, you know,
5 projects that they really needed to do but couldn't do
6 because they didn't have the capital.

7 Q But are there benefits from having access to capital?

8 A I would say yes. There are benefits to having access to
9 capital and increasing financial flexibility. I would say
10 that Premera's RBC is low relative to other Blue Cross/Blue
11 Shield plans. They probably could - it would be beneficial
12 to increase their RBC somewhat. And having the flexibility
13 to tap the capital when you need it, that's a good thing.
14 Financial flexibility is a good thing.

15 For instance, if an exciting acquisition opportunity
16 came along now, they may not be able to do that because they
17 may not have the capital. Whereas, if they were a public
18 company, they can go to the public markets and raise the
19 capital quickly for that acquisition. If there's a bump in
20 the road two or three years down the road, having the
21 flexibility to tap the capital could be a good thing. So I
22 think there are certain benefits associated with having
23 access to capital and enhanced financial flexibility.

24 Q In your view, what are the risks associated with Premera
25 converting and becoming a public company?

1 A Well, I think there are several risks. One risk I think is
2 that there are certain potential negative tax attributes that
3 could happen as a result of the conversion. I think the
4 premium taxes in Alaska might go up a little bit. I think it
5 would go up from 2 to 2.7 percent. They currently have an
6 833(b) deduction and they're able to pay a very favorable tax
7 rate. They pay about a 20 percent effective tax rate on
8 their books.

9 There is a risk that if - as a result of this process
10 and this conversion, they might lose that 833(b) deduction.
11 It's my understanding that that would have no impact on their
12 cash taxes. So they would still pay the same cash taxes
13 because they have other things like net operating losses and
14 tax credits that could offset the earnings. But it might
15 impact their book tax rate. So their book tax rate would go
16 up from the 20 percent level it's at now to a level that's
17 more normal, kind of in the mid to high thirties.

18 There are also, you know, costs associated with being a
19 public company. So I think, you know, basically public
20 companies need to disclose financial statements. There are
21 costs associated with that. Premera has estimated it's about
22 three and a half million dollars a year of costs associated
23 with being a public company. It might even be more than that
24 given Sarbanes-Oxly and some of the demands of Sarbanes-Oxly
25 so I think that's some of the risks and costs.

1 I think also there are some things that we didn't look
2 at in our report but other consultants looked at in their
3 reports such as some of the economic impacts that PwC is
4 looking at. That's not something that we really looked at,
5 but we did obviously read their reports.

6 Finally I would say that when you are a public company,
7 you are under the microscope. And also the public markets
8 are very short-term focused. And sometimes as a public
9 company, you need to think, you know, with more of a
10 short-term focus than a long-term strategic focus because the
11 public markets will want you to demonstrate growing earnings
12 every quarter and every year. And if you missed your
13 earnings, the stock is going to get hit. So companies do
14 need to get used to operating under that microscope and
15 deliver the earnings growth. And sometimes they need to
16 sacrifice long-term projects that may be great for the
17 company, but they're - in the short run, they're not good
18 projects because they might hurt your earnings.

19 So I think those are some of the risks I can think of.

20 Q What are your views on the proposed amount of capital that
21 Premera would like to raise, i.e. the 150 million?

22 A Right. Well, I think the 150 million of capital, the problem
23 that I have with it is it is significantly dilutive to the
24 foundation shareholder. We ran some numbers in our reports.
25 And as I said, Premera has not given us a specific use for

1 this capital. We've asked them many times. And the response
2 has always been, "Well, we would put it in bonds at
3 four percent. And maybe in the longer run, we would find
4 another use for it." But in all the analyses that we got
5 from the company and all the ways we asked, we never really
6 got a response other than this money is going to go into
7 four percent bonds.

8 And the problem is if the money goes into four percent
9 bonds, the deal is extremely dilutive to the foundation. And
10 again, in our report, we calculated 15 percent earnings
11 dilution, assuming \$150 million offering. So that is, you
12 know, 15 percent dilution to the foundation, and that's very
13 significant dilution.

14 Q Could you describe what you mean by dilution in this context.

15 A Right. Basically equity capital is the most expensive form
16 of capital for a company to issue. And investors - there's
17 basically a correlation between the risk that an investor
18 takes and the expected return that they get. And basically
19 the way it works is you kind of look at a company's capital
20 structure and you have the senior lenders. You have the
21 subordinated lenders. You have the preferred stockholders.
22 And then you have the equity holders at the bottom of the
23 capital structure.

24 Well, what happens is when a company gets into trouble,
25 the senior debt holders get paid first; then if there's money

1 left, the subordinated debt holders; then if there's money
2 left, the preferred equity holders; and then if there's money
3 left, the equity holders. A lot of times there's no money
4 left. So the equity holders are in the riskiest position in
5 the capital structure.

6 Because of that fact, equity is the most expensive form
7 of capital. And the cost of equity for Premera is probably
8 above 10 percent. I mean it's very expensive capital. Debt
9 capital, you know, is kind of in the mid single digits. But
10 equity capital, if they were to issue it, would be very
11 expensive. And the expense is not through an ongoing
12 payment. Some companies do pay a dividend. But the expense
13 basically is coming - because you're giving up ownership in
14 the company. And that is very expensive to do. And again,
15 there's a cost associated with that.

16 And so there's basically three types of dilution. The
17 first type of dilution is ownership dilution. If I own a
18 hundred percent of the company today and the company sells
19 stock, I will own less than a hundred percent. But ownership
20 dilution is not necessarily a bad thing because even though I
21 own less than a hundred percent, maybe the pie is bigger. So
22 it's, you know, if you own less of a bigger pie, you may be
23 better off. Okay. So that's ownership dilution.

24 Earnings dilution looks at this year's earnings and
25 next year's earnings and it says assuming we take this

1 capital that we're going to raise, the company raises, and we
2 put it to whatever use we're assuming, what happens to the
3 earnings of the company? And again, this is what I was
4 talking about earlier, this 15 percent dilution. Assuming
5 Premera raises 150 million of very expensive equity capital,
6 you know, and puts the money in four percent bonds, it's
7 going to be 15 percent dilutive to the earnings of the
8 company. And the reason that's bad is because the foundation
9 shareholders, if they're going to sell stock, they're going
10 to sell it based on those pro forma earnings, whether it's at
11 the IPO or in the aftermarket. So they're going to be
12 selling this stock at a much lower value because of this
13 dilution. So that is earnings dilution and that can lead to
14 lower valuations being realized on sales in the aftermarket.

15 And the last type of dilution is value dilution. And
16 that goes to what does the company do with the proceeds
17 long-term? Okay. And if they have a good use for the
18 proceeds and it is higher than their cost of that capital -
19 so if the cost of capital let's just say for argument sake is
20 10 percent and they have a use for that money that can earn
21 15 percent, then it will be value accretive. It won't be
22 value dilutive. And it's very possible that a company can do
23 something that's dilutive to earnings but accretive to value
24 because maybe you have a project that has low earnings in the
25 first couple of years but then has very high earnings, you

1 know, five years from now.

2 Now, that's a possibility. But we have never received
3 any type of proposal or analysis from Premera that showed us,
4 you know, how this \$150 million of money that they were going
5 to raise could be value accretive.

6 So those are basically the three types of accretion or
7 dilution.

8 Q If Premera completes an IPO transaction that is significantly
9 earnings and/or value dilutive, could that result in the
10 foundation receiving less than fair market value in the
11 conversion?

12 A Yes. And that's - those are the points I just made. If our
13 earnings are diluted by 15 percent, you know, it could really
14 result in us getting less than fair value for our stock
15 sales. And if, you know, the money is - a lot of money is
16 raised and there's not a good use for it, again, that's value
17 dilutive to us, as the owners of a hundred percent of the
18 stock. Now, I'm not saying that, you know, we couldn't have
19 any dilution. A little bit of dilution might be okay,
20 because if the offering is three or four percent dilutive,
21 that might be okay. But 15 percent dilutive, that presents a
22 problem and is inconsistent with delivering fair market value
23 to the foundations.

24 Q Is it possible that a rising stock price post-IPO could
25 offset the negative impact of the dilution?

1 A Well, I think it's possible. But there's no guarantee that
2 the stock is going to go up. Okay. The stock can go up and
3 it can go down. And there's no guarantee it's going to go
4 up. The other thing I would say is there's not necessarily a
5 correlation between the dilution to the foundation and how
6 the stock performs. So it's possible we could have less
7 dilution and the stock going up. And I think we'd prefer to
8 have that than 15 percent dilution and the stock going up.

9 So again, I don't think they're related. And I still
10 think we would - you know, we would not be able to recommend
11 a transaction where it's 15 percent dilutive to the
12 foundation.

13 Q In your experience or to your knowledge, have other Blue
14 Cross/Blue Shield companies raised significant amounts of
15 primary capital in other conversions?

16 A Well, we have looked at what other companies have done.
17 WellChoice, which is the most recent deal, raised very little
18 capital. They did - their total offering was in the
19 \$300 million range and the company itself raised less than
20 \$30 million in capital. So the company only raised about
21 \$30 million in capital out of an offering of about 300
22 million. In Trigon, I don't think the company raised any
23 capital, any primary capital.

24 So in other Blue Cross/Blue Shield conversions, these
25 companies have not raised the amounts of capital that Premera

1 is talking about raising.

2 Q In your view, have public Blue Cross/Blue Shield companies
3 been significant issuers of equity capital for proceeds?

4 A We also looked at this in our report. We looked at over the
5 last five years, the - basically the health insurers who are
6 public, were they raising a lot of equity capital. And the
7 answer was that they were paying more to investors in
8 dividends than they were getting from investors in raising
9 equity capital. They were returners of equity to the market,
10 with one exception. The companies that did significant
11 acquisitions issued a lot of equity capital. So basically
12 our study . . . And again this study is for the last five
13 years. And maybe if you looked at a longer period or
14 different period, you might get a different result. But for
15 the last five years, the public companies, health insurance
16 companies, were basically returners of capital unless they
17 were doing major acquisitions, and then they were issuing
18 capital to finance those acquisitions.

19 Q How many Blue Cross/Blue Shield companies are still public
20 companies?

21 A There's three. But there will be two.

22 Q Which one is going away?

23 A Anthem and WellPoint are combining. So there'll basically be
24 Anthem and WellChoice.

25 Q In your due diligence, did you look at the benefits of a sale

1 as opposed to an IPO for stock?

2 A We - as I said, we were basically given guidance that an IPO
3 conducted - a customary IPO conducted, you know, kind of
4 similarly to other IPO's that have been done could satisfy
5 the fair market value test. So we did not look at the sale.
6 But there are certain benefits and issues associated with
7 doing a sale.

8 Q Okay. I'd like to move on to some issues regarding
9 valuation. What issues might there be with respect to the
10 size of Premera's IPO?

11 A Well, I think there are a few points and some of them I've
12 touched on. I think one is the float, the public float. And
13 I think we have looked at what's been done in other Blue
14 Cross conversions. We've also, in our work with
15 demutualizations, have a good sense. And I think in Blue
16 Cross conversions, the float is approximately - the average
17 is about 20 percent. Now, some have been lower than
18 20 percent and some have been higher than 20 percent. And
19 again the float is the amount of stock that's held by the
20 public as opposed to held by the foundation. So that's the
21 first point.

22 You know, you typically after the IPO, you know, the
23 average will be 20 percent of the stock in the public's
24 hands, although it could be less and it could be more. Okay.

25 The second issue is of the stock that gets sold at the

1 IPO, how much of that is company shares and how much of that
2 are foundation shares? Now, as I've said, if the company
3 doesn't have a good use for the proceeds, that can result in
4 significant dilution. So there might - you may want to think
5 about limiting the amount of stock the company sells to
6 ensure that the foundation doesn't get diluted too much,
7 recognizing that the company may have a need for a little bit
8 of capital to bolster their RBC ratio.

9 Now, the foundation may want to sell some shares
10 because they may want to get some liquidity and they have a
11 lot of selling to do in the next three to five years. They
12 need to sell a lot of stock. So they may want to sell some
13 stock in the IPO. As I said, in WellChoice, the foundation
14 sold some stock, significant stock, in the IPO.

15 Now, there is an issue with the foundation selling too
16 much stock in the IPO because there's something that's called
17 an IPO discount. And typically IPO's are priced at a
18 discount to where public companies are trading in the market.
19 And the reason for that is if an investor has a choice to
20 invest in a public company that's already in the market and a
21 new IPO, they're going to, all else equal, invest in the
22 public company that's already trading because it has a track
23 record.

24 So to induce investors to invest, you know, in new
25 issue, there's a discount. And it's usually 15 percent. For

1 Blue Cross/Blue Shield conversions, it's actually been a
2 little more than 15 percent. So if the foundation is selling
3 stock at the IPO, they have to recognize that they may be
4 selling it at a little bit of a discount. But again, I think
5 they would want to sell some stock given liquidity needs and
6 given their divestiture schedule. So it really is a
7 balancing of several factors.

8 Q Did Blackstone complete a valuation analysis of Premera?

9 A We did not do a valuation analysis. As I said, it was
10 determined and we were given guidance by our client and by
11 the legal advisors to our client that an IPO properly
12 conducted could satisfy the fair market value test that, you
13 know, we'd need to satisfy.

14 Q How would you propose ensuring that the foundation receive
15 fair value in an IPO?

16 A Well, typically what's done in these conversion transactions
17 is that the advisor for the state - and we have done this in
18 many transactions - would issue something called a procedures
19 opinion. And what a procedures opinion says is that
20 basically the IPO - the marketing of the IPO is consistent
21 with other IPO's with the rationale that if you have an IPO
22 that is marketed in a way that's consistent with other IPO's,
23 it'll result in a price that is a good price and a fair
24 price.

25 And what we would do in a procedures opinion is we

1 would basically, you know, work with the company to review
2 the company's marketing materials, review the offering
3 documents, you know, review and comment on the S-1, attend
4 the road show presentations, have daily calls or, you know,
5 every-other-day calls with the capital markets desk at the
6 lead underwriter to see how the book is building, the order
7 book, you know the book of orders for the IPO is building,
8 and really just monitor that very closely, and then basically
9 at the end, say, "Okay these guys did a good job," and put
10 our stamp of approval and write a procedures opinion. And
11 that's how we would do that typically.

12 Q And is that planned in this conversion?

13 A Yes. We have - in the Revised Form A filing, we do have a
14 procedures opinion in place or the kind of concept that we
15 would give a procedures opinion. That is contemplated in the
16 Revised Form A filing.

17 Q Have all of your concerns relating to monitoring the IPO been
18 addressed in Premera's Revised Form A filing?

19 A I believe they have. We did have one concern in our report
20 and that's we wanted to get the company's proposal related to
21 the size of the IPO, the split between the shares that the
22 company planned to sell versus the shares that we would get
23 to sell, the preliminary pricing range. We wanted to get
24 that at least four weeks prior to the start of the road show.
25 And the reason for that is this is something that not only

1 goes to our procedures opinion, but also goes to our
2 bring-down fairness opinion in that we're still concerned
3 about this dilution issue. It hasn't gone away. But we've
4 kind of postponed our evaluation of it and put procedures in
5 place so we can monitor it and we can comment on it at the
6 right time. Because really now it's very difficult to say
7 this far in advance of when the IPO is going to take place
8 how big the IPO is going to be and how many shares the
9 foundation should sell and how many shares the company should
10 sell. It's too far off. So we've tried to put a mechanism
11 in place to deal with that.

12 Now, we really need to get that information at least on
13 a preliminary basis from the company at least four weeks
14 prior to the road show. Because once the company is out on
15 the IPO road show, it's really too late; the train has left
16 the station. If we're going to have concerns, we need to
17 raise them before they go on the road show. So we need to
18 get the information, analyze it, go through it with our
19 client, probably have some meetings with the client to
20 discuss it and figure out what the right outcome is with the
21 company.

22 But that wasn't in the Revised Form A. But in Kent
23 Marquardt's pre-filed testimony, we believe the company is
24 amenable to having that four-week window for us to review the
25 information.

1 Q Could you briefly tell us what the purpose of the bring-down
2 certificate and bring-down opinion is?

3 A Right. Well, assuming we can work out the remaining issues
4 that we have, we would issue something called a fairness
5 opinion, basically, as I discussed earlier, stating that the
6 transaction is fair. And we would give that to the
7 Commissioner and it would feed into his order on the
8 transaction.

9 Now, the problem is that the company has a year to
10 complete the IPO. From the time of the order, the company
11 has a year - an IPO window, a year to complete the IPO. And
12 a lot can happen in a year. And so we will give an opinion
13 at the time of the order. But then we need to give what's
14 called a bring-down opinion closer to the date of closing
15 that basically says, "All the things that we said about the
16 deal being fair, those are still true, you know, and now
17 you're ready to do the IPO and those are still true."

18 And also we need to work in these issues related to the
19 size of the IPO or the dilution that I just discussed. And
20 so the bring-down certificate is basically a piece of paper
21 where the company says, "There have been no changes" - and
22 there is a list of specified items in the Revised Form A
23 filing - "And if there have been changes, we've disclosed it
24 to you." And it has a specific set of items where they have
25 to disclose these changes.

1 Now, there are two items that are still open. We want
2 the company to disclose to us if there's a change of more
3 than 25 points in the risk-based capital ratio. They are
4 proposing they would only have to disclose something to us if
5 the change in their risk-based capital ratio is more than
6 50 points. We believe that given how much discussion the
7 company has made about RBC and the emphasis they've placed on
8 RBC, we really want to know if their RBC moved more than
9 25 points. And it's not saying we're not going to approve
10 the deal and not going to be able to give a bring-down
11 opinion. It's just saying, "Let us know so we can factor it
12 into our analysis." So that's one point.

13 The second point is we wanted to just broaden the
14 scope. We wanted them to disclose to us if there are changes
15 to any opinions. And so I think we'll just broaden the
16 definition a little to include legal opinion. So if a legal
17 advisor to the company, between the time of the
18 Commissioner's order and the time of the IPO, changes their
19 mind and says, "We gave you this opinion before; now we're
20 giving you a different opinion," we want that disclosed to us
21 so we can factor that into our analysis.

22 Q Why does Premera need a year to complete the IPO?

23 A Well, I think there is a potential for market dislocations.
24 There are periods when the IPO market is closed for business.
25 You cannot do an IPO. And sometimes those dislocations can

1 last, you know, a few months. Sometimes they can last as
2 long as six or nine months. So you need to have the
3 flexibility to get the IPO done. And I think a year window,
4 while it sounds long, gives the company adequate flexibility
5 to do their IPO. And I think it is consistent what what's
6 been done in other transactions as well.

7 Q Are the automatic three-month extensions proposed by Premera
8 consistent with other conversions?

9 A We do not believe those are consistent with other
10 conversions. We have worked on deals, for instance, MetLife,
11 where there was a one-year window to complete the IPO and
12 there was no automatic extension. WellChoice did not have an
13 automatic extension. And our feeling is, "Look, take a year.
14 Get the IPO done. That's a very generous window to do the
15 IPO. And if you can't get it done in a year, come back to
16 the Commissioner. Tell him why you can't get it done, and
17 let him decide if you deserve a three-month extension or a
18 six-month extension."

19 Because a year is a long amount of time. And we're
20 trying to put in safeguards such as the bring-down
21 certificate. But, "If you're going to go beyond a year -
22 which is a very generous window; it's very consistent with
23 what's been done in other deals - you know, let the
24 Commissioner make that determination."

25 Q Why is it important, in your opinion, for the OIC's financial

1 advisor to be able to share its analysis and findings with
2 the Washington foundation?

3 A Well, the Washington foundation needs to make some decisions
4 with respect to the IPO. They need to decide if they want to
5 sell stock, how much stock they want to sell and, you know,
6 someone needs to help them with that analysis and they need
7 to monitor the IPO and kind of know what's going on.

8 Now, in WellChoice, the foundation actually got to a
9 point, a co-manager for the IPO. We're not getting that
10 right here. That's one of the areas where WellChoice is
11 actually more favorable, or actually less favorable, from the
12 foundation's perspective, than our deal. But we're not
13 getting that right here.

14 But Blackstone is going to be monitoring the IPO, as
15 the advisor to the OIC. And our thinking was, "Look, we need
16 to let Blackstone communicate with the foundation shareholder
17 to share what - their knowledge and help them make those
18 decisions."

19 Now, the plan is silent on this. It doesn't say we
20 can't do it, but it doesn't say we can do it. And we just
21 want it to be perfectly clear that when we go to talk to the
22 foundation, the company doesn't say, "Oh, you're not allowed
23 to do that," because that would be a disaster.

24 Q So you're asking for more clarification on that?

25 A Yeah. We just want it to be crystal clear that that's

1 something we're allowed to do because it's silent in the
2 plan.

3 Q I'd like to move on to the allocation between the states.

4 A Sure.

5 Q What analysis did you complete to analyze the allocation of
6 value between Washington and Alaska?

7 A Well, we did two allocation reports, one in August of '03 and
8 then we did a revised one in March of '04 which was based on
9 revised numbers. But basically what we did was we looked at
10 several financial and operating metrics and we broke it out
11 by state. We said here's what these metrics are for
12 Washington. Here's what these metrics are for Alaska. And
13 we looked at several items. We looked at members. We looked
14 at revenues. We looked at contribution margin. We looked at
15 underwriting margin. We looked at operating profit. And we
16 looked at net profit. And we looked both historically and we
17 looked for projected information as well.

18 And we took a look at those numbers and we said, "Okay.
19 What is each side bringing to the party?" Okay. So that was
20 kind of one thing that we did.

21 We also thought about qualitative factors. And any
22 time we do a valuation, we think about the numbers. We think
23 about quantitative factors, but we also think about
24 qualitative factors. And basically, in our view, our
25 conclusion was that a dollar of earnings in Washington is

1 worth more than a dollar of earnings in Alaska because
2 Washington's business has much higher growth prospects. And
3 the market values growth. So the equity markets, when they
4 value companies, they really look at growth. And Alaska
5 already has a very high market share. They're 80 percent
6 market share, if you include the government business. And
7 they basically have a very high market share. They don't
8 have the room to grow. Washington is where all the growth is
9 coming from, if you look at the company's projections. So
10 that was one factor.

11 The second thing is we think the market also rewards
12 scale. And we think Alaska by itself doesn't have the scale
13 that Washington has.

14 And so both in terms of growth and in terms of scale,
15 Washington gets the edge. So qualitatively, when we were
16 thinking about the numbers, obviously we kind of weighted a
17 dollar of earnings more for Washington than for Alaska.

18 The other thing that I would add is when we looked at
19 the pure numbers, we got a very different result than when we
20 looked at the numbers that included allocations of expenses.
21 And basically the members, the revenues, the contribution
22 margin and underwriting margin are much purer numbers.

23 When you get to operating profit and net profit, you
24 have allocations of expenses. And we basically worked with
25 the actuaries, but it was very hard for us because we didn't

1 think the allocation of expenses made sense. Basically - or
2 basically - maybe Blackstone doesn't even have a point of
3 view on that - but our actuaries kind of advised us that some
4 of these allocations didn't make sense. So we put less
5 emphasis on operating profit and net profit because these
6 included these allocations which, to our actuaries, you know,
7 didn't make sense. And there was some results that just were
8 just not kosher. So basically we did all of that. We looked
9 at the numbers. We looked at the - we thought about the
10 qualitative factors. And basically what we found is that all
11 of the numbers kind of pointed to a range for Washington in
12 the mid eighties to the high eighties. Some of the numbers
13 even pointed to a range, you know, in the low nineties. But
14 I think putting it all together, our range was 83 to
15 89 percent for Washington.

16 Q Are you aware of the range of the Alaska advisors?

17 A Yes.

18 Q And how did their methodologies differ than yours.

19 A Well, as we had an investment banking advisor looking at this
20 and an actuarial advisor looking at this, Alaska did that as
21 well. And their range - their investment banker had a range
22 in the mid fifties to the low seventies for Washington. And
23 I believe their actuarial range was in the low seventies. So
24 their range was very different from ours. And I think there
25 was a few things that were different.

1 Their investment banking consultant didn't do what I
2 would call a typical investment banking analysis. They did
3 more of an actuarial analysis. They looked more at
4 historical results than at future results. And they also
5 didn't think about how the market might weight a value, you
6 know, a dollar of earnings, differently for Washington versus
7 Alaska. So they did more what I would call a historical,
8 backward-looking actuarial approach.

9 Q Okay. I have two more questions.

10 A Okay. Great.

11 Q In your opinion, do stock options have value when they're
12 issued?

13 A Yes. Stock options do have value. An option gives someone
14 the right to do something. And that right is valuable. And
15 basically the option has a term. And the longer that term,
16 the more valuable that right is because you are basically
17 getting the right to buy a stock, which is a very volatile
18 stock, at a set price for a long period of time. The
19 probability is if the time period is long enough, that at
20 some point in the future, the stock will be worth more than
21 the exercise price.

22 And so options have value. Options trade in the
23 market. You can trade options. There's a market for options
24 and people buy them because they're very valuable. And I
25 think right now there's a big debate going on about whether

1 options should be expensed on the profit and loss statement
2 because there really is a cost associated with issuing
3 options. They have value. So I would say the answer is
4 definitely yes.

5 Q And lastly, based upon your discussion of the dilution to the
6 foundation shareholder, Washington foundation, do you believe
7 that the foundation would be - would not get the fair market
8 value of a hundred percent of the stock?

9 A Well, again, I think we're operating under the data that we
10 have seen so far. And we have seen - we have not seen any
11 data that says, you know, "We would raise \$150 million and
12 here are the projects that we would do and here's the return
13 and here's why this is a great investment."

14 All we have seen so far is, you know, "We're going to
15 raise \$150 million. We're going to put it in four percent
16 bonds."

17 And if you do that, it is extremely dilutive to the
18 foundation. And I do think that that would hurt the ability
19 or really it would make us unable to give a fairness opinion.

20 MS. deLEON: Thank you. No further questions.

21 MR. MITCHELL: Your Honor, it's 10 minutes before
22 3:00. And I'm wondering if you would like me to break at a
23 particular point for the afternoon after I begin my cross.

24 JUDGE FINKLE: How long would you expect to be on
25 cross?

1 MR. MITCHELL: 45 minutes.

2 JUDGE FINKLE: How long, if at all?

3 MS. McCULLOUGH: 20 to 30.

4 JUDGE FINKLE: We could break now I think.

5 MR. MITCHELL: We could do that. Or I could break
6 in the middle, too.

7 JUDGE FINKLE: If there's a 10-minute breaking
8 point, fine. Otherwise let's break now.

9 (Afternoon recess.)

10 JUDGE FINKLE: Ready to proceed.

11 MR. MITCHELL: Thank you, your Honor. Good
12 afternoon, Mr. Koplovitz.

13 THE WITNESS: Good afternoon.

14

15 CROSS-EXAMINATION

16

17 BY MR. MITCHELL:

18 Q I'd like to begin by discussing an advantage to conversion of
19 Premera if I might. In your original report, you noted that
20 Premera's 2001 RBC level, which was 420, was fourth lowest
21 among reporting Blue plans and 30 percent below the
22 systemwide average of 599 percent. Do you remember that?

23 A Yes.

24 Q Now, as Mr. Marquardt testified yesterday, the gap between
25 Premera's RBC and that of the systemwide average has widened.

1 Is that not true?

2 A That was his testimony.

3 Q And in 2002, Premera's RBC, which was 406, was 35 percent
4 below the systemwide average of 623. Is that not right?

5 A I believe that's correct.

6 Q And in 2003, it's 39 percent below the systemwide average of
7 712 percent. Does that sound right?

8 A I haven't done the calculation.

9 Q Would you agree with me, Mr. Koplovitz, that improving
10 Premera's RBC level would offer a number of benefits to
11 Premera and its subscribers?

12 A As I testified, I think there is some benefit to improving
13 the RBC. But I view it more of a balance. I believe there's
14 a balance between strengthening the balance sheet and
15 diluting the existing shareholders. So I think you need to
16 strike a balance. But as I did testify, there is some
17 benefit to improving the RBC and gaining access to capital.

18 Q Now, you've mentioned, by the way, in your answer to my last
19 question existing shareholders. There are no existing
20 shareholders, are there?

21 A What I was referring to is --

22 Q Mr. Koplovitz, I'm sorry. I think that's a yes or no answer.

23 A At this time, no.

24 Q Would you agree with me, Mr. Koplovitz, that among the
25 benefits of improving Premera's RBC level would be greater

1 security for Premera's members?

2 A It's possible.

3 Q Would you agree with me, Mr. Koplovitz, that improving
4 Premera's RBC would provide more capital to invest in
5 infrastructure improvements, new and expanded services and
6 products to Premera's subscribers?

7 A Assuming they had those needs, I would agree with you.

8 Q Would you also agree with me, Mr. Koplovitz, that improving
9 Premera's RBC level would give Premera the wherewithal to
10 grow and to bring competitive products to more of the
11 insurance-buying public?

12 A It might.

13 Q Now, the benefits of going to the equity markets to secure
14 capital to boost Premera's RBC level are not just a one-time
15 shot in the arm, are they? If Premera becomes a
16 publicly-traded company, does it not also have the ability to
17 return to the market as needed to boost its capital reserves?

18 A That's correct.

19 Q And I believe as you have testified, that there is a benefit
20 in having financial flexibility, particularly for a company
21 unlike an insurance company that has substantial capital
22 needs. Is that not true?

23 A Yes. There are benefits with having financial flexibility.

24 Q And in this case, that's a significant benefit of Premera's
25 proposal to Premera's subscribers and to the insurance-buying

1 public, is it not?

2 A Yes. It might be a benefit to subscribers and the
3 insurance-buying public.

4 Q Now, if we consider these benefits that we've just gone
5 through, Mr. Koplovitz, and set aside for a moment the risks
6 associated with conversion, would you not agree with me that
7 the - these considerations amount to a compelling case for
8 conversion?

9 A I think if you consider the benefits without considering the
10 risks, it is a compelling case.

11 Q And certainly, Mr. Koplovitz, you have no reason to doubt
12 that Premera's board looked at these issues and found them to
13 be compelling reasons to go ahead with conversion, do you?

14 A I'm sorry. Could you repeat the question.

15 Q Certainly. You have no reason to doubt, do you, that
16 Premera's board examined these benefits of conversion and
17 found them to be compelling?

18 A I have no reason to believe that . . . Yeah. I believe they
19 did examine these factors.

20 Q Now, in addition to the benefits to Premera, its subscribers
21 and the insurance-buying public from this proposal, would you
22 not also agree that Premera's conversion proposal will result
23 in substantial capital going to the Washington and Alaska
24 foundations?

25 A Assuming the conversion goes through?

1 Q Yes.

2 A Yes.

3 Q And that - would you not also agree that such capital could
4 be used to benefit the public in addressing unmet health
5 needs in this case?

6 A I haven't studied that. But I would imagine if there's
7 capital in the foundations and they're going to spend that
8 capital on unmet health needs, I would imagine that that
9 capital could benefit unmet health needs.

10 Q Now, I'd like to turn to the question of timing,
11 Mr. Koplovitz. In your business, I think timing is a pretty
12 important issue. Is it not?

13 A I'm not sure what you mean.

14 Q Well, let me be more specific if I might. This is a pretty
15 good time to go to the equity capital markets, is it not?

16 A Yes.

17 Q And in the equity capital markets, Blue Cross/Blue Shield
18 companies have been well-received, have they not?

19 A Yes.

20 Q Even more specifically, is it not the case that Premera would
21 be an attractive IPO candidate?

22 A I believe they would be an attractive IPO candidate.

23 Q Among the reasons for Premera's attractiveness is that it's
24 about the right size; it has a lot of attractive qualities;
25 it's had a good growth trajectory over the last few years.

1 That's all true, is it not?

2 A I believe I - that's my quote you're using.

3 Q And I take it you still agree with the quote.

4 A I do agree with that quote. Haven't changed my mind.

5 Q And the market for such companies is still pretty good, is it
6 not?

7 A Yes.

8 Q Now, beyond this right size, the good growth trajectory and
9 so forth, is it not the case, Mr. Koplovitz, that Premera
10 scores well on all the fundamentals that investors today are
11 focusing on, and these include transparency, profitability,
12 cash flow, rising returns, sector leadership and high quality
13 management?

14 A I . . . Yeah. I believe Premera would be a compelling
15 candidate for a public offering. You know. If you want to
16 go through each of those points, we can go through them. But
17 those are your points. I think you read my language.

18 Q And to be more specific, Mr. Koplovitz, those qualities are
19 all strong points for Premera, are they not?

20 A Maybe if you want to go through them, we can go through them.

21 Q Well, let's focus initially upon high quality management. Do
22 you agree that that's a strong point for Premera?

23 A Yes. We have had interaction with the management team and we
24 think they would be capable of running a public company.

25 Q Now, Blackstone looked at the factors that could affect the

1 value of Premera in an IPO, did it not?

2 A Yes.

3 Q And you looked at both positive factors and negative factors
4 and you determined that the positive factors outweigh the
5 negatives. Is that not true?

6 A I think we had a list of positive factors and negative
7 factors. I don't know what you mean when you say they
8 outweighed them.

9 Q That's a fair point, Mr. Koplovitz. I think the list that
10 you're referring to is on page 33 of your original report.
11 And I believe if you count up the positive factors, there are
12 ten of them, and if you count up the negative factors, there
13 are eight of them. I did not mean to suggest other than
14 that. Can you confirm that for me, please.

15 A Sure. Yeah. That looks right, ten and eight.

16 Q Now, among the negative factors was this one: I quote,
17 "Premera has significantly lower RBC ratio than that of other
18 BCBS plans," closed quote. Is that right?

19 A That's correct.

20 Q So the fact that Premera is currently at a relatively low
21 capital position could put a damper on how well-received this
22 IPO is; is that not true?

23 A Well, I think it's a factor that people would consider. I
24 don't know if it would put a damper on the IPO, given the
25 levels it's at now.

1 Q Actually when you originally wrote this factor, did you not
2 say that Premera - and I quote - "has significantly lower RBC
3 ratio than that of other BCBS plans which could impair its
4 ability to fund required capital investments over the long
5 term"?

6 A Yeah. I'm not - I don't remember if that's what we
7 originally wrote or not.

8 MR. MITCHELL: May I approach, your Honor?

9 JUDGE FINKLE: Yes.

10 Q (BY MR. MITCHELL) I've shown you - handed you a copy of
11 Exhibit P-147, Mr. Koplovitz, which is now up on the ambo as
12 well as before you. Does that refresh your recollection that
13 the language that was in the Blackstone report initially had
14 the clause "which could impair its ability to fund required
15 capital investments over the long term"?

16 MS. deLEON: Your Honor, I would like . . . This
17 e-mail is not to Mr. Koplovitz. It's not from Mr. Koplovitz.

18 MR. MITCHELL: Well, let me lay a bit of
19 foundation, if I might.

20 MS. deLEON: Thank you.

21 Q (BY MR. MITCHELL) Mr. Koplovitz, who is Nicholas Lardo?

22 A Nicholas Lardo is one of the members of the deal team.

23 Q For Blackstone?

24 A Yes.

25 Q And was this a communication from Mr. Taktajian, who is

1 Mr. Cantilo's associate and Cantilo & Bennett, to Mr. Lardo,
2 a member of your team?

3 A Looks that way.

4 Q Now, does this refresh your recollection, Mr. Koplovitz, that
5 in the original Blackstone report, you made reference to the
6 potential impairment of Premera's ability to fund required
7 capital investments over the long-term because of its
8 significantly lower RBC ratio?

9 MS. deLEON: Your Honor, objection. There still
10 has been no foundation established regarding Mr. Koplovitz's
11 knowledge of this e-mail.

12 JUDGE FINKLE: Sustained.

13 Q (BY MR. MITCHELL) Mr. Koplovitz, did you receive from
14 Mr. Lardo information indicating that there had been a
15 request made to change the language in the Blackstone report
16 in respect to this particular issue?

17 A I don't recall this specific e-mail. I don't recall Nick
18 Lardo telling me we had to change anything. Between the time
19 we issue a draft and the time we issue a final report, there
20 are a lot of changes that are made, so I don't remember this
21 specific change.

22 Q Do you remember, Mr. Koplovitz, that in the earlier draft of
23 the Blackstone report - this would be a week before the
24 initial draft consultant reports came out - that there was
25 reference to the potential negative factor associated with

1 the lower RBC ratio, specifically that it could impair
2 Premera's ability to fund required capital investments over
3 the long term?

4 A I don't recall that.

5 Q In any case, Mr. Koplovitz, would you not agree with me that
6 if Premera were to wait until its RBC position got worse, for
7 example, through one or more of the scenarios that
8 Mr. Marquardt described yesterday, that the negative factor
9 that you identified here on page 33 of your report would loom
10 much larger in the eyes of potential investors?

11 A Yes. That's a possibility.

12 Q Certainly you would not recommend, would you, Mr. Koplovitz,
13 that Premera wait until its capital needs are acute before
14 seeking equity?

15 A I think yes, if Premera's capital needs were acute, it would
16 be more difficult to raise equity than it is now.

17 Q And I think Mr. Kinkead testified that companies are better
18 able to raise capital when they're in a strong financial
19 position. Do you agree with that?

20 A Well, depends on what you mean by strong financial position.

21 Q Well, let me ask the question this way: Would you agree that
22 for a health insurance company such as Premera, that having a
23 dramatically constrained capital position would make it more
24 difficult to raise capital than proceeding under the current
25 circumstances?

1 A It might.

2 Q And would you not also agree, Mr. Koplovitz, that if Premera
3 waited to convert until its capital position worsened, that
4 that could cost the foundations tens if not hundreds of
5 millions of dollars?

6 A Difficult to say.

7 Q Worst case scenario, Mr. Koplovitz, would be that Premera
8 would not even have the option of going to the equity markets
9 and would end up being sold for a pittance. There are some
10 examples of that among nonprofit Blue Cross/Blue Shield plans
11 around the country, are there not?

12 A There are examples of plans who ran into financial problems
13 and had to be bailed out by other plans. That has happened
14 in the past.

15 Q Let's return to the happier state that we're in now. Premera
16 is strong. I believe you testified it's poised to continue,
17 to compete and to grow. It needs the capital and financial
18 flexibility that conversion would bring. You concur, do you
19 not, Mr. Koplovitz, with the board and its financial advisors
20 that this is a favorable time to pursue conversion?

21 A I do concur that the equity markets are favorable at this
22 time for Blue Cross/Blue Shield health insurance companies.

23 Q I want to discuss with you now the concerns of the OIC
24 Staff's consultants and, in particular, the concerns
25 expressed by the Blackstone Group. First I think you will

1 agree with me, will you not, Mr. Koplovitz, that we've come a
2 long way since the original consultant reports were issued
3 last October?

4 A Yes. I would agree with you.

5 Q Specifically the original Blackstone report expressed a
6 number of concerns about the transaction terms based in part
7 upon a comparison of Premera's original Form A proposal with
8 the recently completed WellChoice conversion. Is that not
9 true?

10 A We looked at WellChoice. We also looked at other precedent
11 conversions. And we did have more issues in our original
12 report than in our amended report.

13 Q In addition, you were concerned last October about the terms
14 of Premera's proposed equity compensation program, which you
15 had only recently received. Was that not true?

16 A We did have issues with their equity compensation program.

17 Q As a measure of how far the parties have progressed, I want
18 you to take a look at the list of issues compiled by
19 Blackstone in early December on the eve of the discussions
20 between the OIC Staff and Premera that have been authorized
21 by dint of the extension in the schedule granted by
22 Commissioner Kreidler and the Intervenor observing. Do you
23 recall that there was such an issue list prepared by
24 Blackstone last December?

25 A I do recall the issues list.

1 MR. MITCHELL: May I approach, your Honor?

2 JUDGE FINKLE: Yes.

3 MR. MITCHELL: That's Exhibit 105. Do you have
4 it?

5 MS. deLEON: Okay.

6 Q (BY MR. MITCHELL) Initially, Mr. Koplovitz, can you confirm
7 that the initial list was transmitted by the same Mr. Lardo
8 that we talked about earlier?

9 A Yes.

10 Q Mr. Koplovitz, I wonder if you would please tick through the
11 items that are listed on the list of outstanding issues here
12 dating from December of 2003 and tell us where those issues
13 now stand.

14 A Right now I'd preface this to say that Martin Alderson Smith
15 is going to be testifying on the transaction issues. I can
16 do my best and go through this list if you'd like. But he is
17 the primary expert on those matters and he will be testifying
18 on those issues.

19 Q Please do your best, Mr. Koplovitz. We've done this once
20 before, have we not?

21 A I think that's true. The first issue, the possibility of the
22 plan becoming effective prior to the IPO effective date. My
23 belief is that that was still an issue in our revised report,
24 but that's been corrected in Kent Marquardt's pre-filed
25 testimony.

1 Details on the foundation shareholder's ability to
2 vote. I believe there's still a small issue outstanding
3 there with respect to change of control proposals and which
4 proposals we would get to vote on and which ones we would
5 not.

6 The trustee services. I believe that's been resolved.
7 Indemnification of the trustee. I believe that's been
8 resolved.

9 Restrictions on the ability to sell under Rule 144. I
10 believe that's been resolved.

11 The length of the holdback period. That's been
12 resolved.

13 Length of restriction period for granting options.
14 That's been resolved.

15 Which employees would be eligible for broad-based
16 grant. That's been resolved.

17 Potential protections against Premera utilizing its
18 shares reserved for option grants. That's been resolved.

19 Maximum individual grants for options. That's been
20 resolved.

21 Elective stock purchase plans for senior management.
22 That's been resolved.

23 Shareholder rights plan. That's been resolved.

24 Size of the IPO split between primary and secondary
25 shares and mechanisms to minimize dilution. I think we

1 talked about that a fair amount, and I think there's been a
2 mechanism in the plan to address that issue. And obviously
3 we would need to revisit it as we got closer to the IPO date.

4 Top-out mechanism. That's been resolved.

5 The terms and procedures for monitoring and evaluating
6 the IPO. Again, I think we discussed that, and I think
7 that's been put into the plan.

8 Q There's a second heading there under "Predominantly
9 Addressed." Can you go through those, please.

10 A Yes. Foundation will be entitled to designate one board
11 representative on Premera's board. I believe that was still
12 an open issue in the amended plan or there was one board
13 representative for Alaska and Washington. And now I think,
14 based on some of the pre-filed testimony, that the Blue Cross
15 has said that it would accept a board member for both Alaska
16 and Washington. So I believe that is a resolved issue.

17 Threshold for voting on a change of control
18 transaction. Again, I think that's still an open issue.

19 Elements of the standstill provision. I believe that's
20 been resolved.

21 Observation rights on the foundation shareholders
22 board. That's been resolved.

23 The divestiture schedule should be changed to be
24 consistent with WellChoice. I believe there's still an open
25 item there. There's still an 80 percent restriction at the

1 end of the first year. And I believe in WellChoice, there
2 was no 80 percent restriction. And I think this is one of
3 the issues that the Blue Cross/Blue Shield has objected to.
4 But I believe that's still an open issue.

5 Exceptions for demand registrations. I believe that's
6 been resolved.

7 The option to purchase foundation shares. I believe
8 that's been resolved.

9 And the no tax indemnification. I believe that's been
10 resolved.

11 Q Do you recall, Mr. Koplovitz, that after the issues list that
12 we just went through was circulated, sent off to Mr. Hamje,
13 with the OIC Staff, by Nick Lardo in your office, that
14 Mr. Taktajian weighed in with some observations about the
15 list.

16 A It's possible. I don't recall a specific call to discuss
17 that. But we did have lots of calls with the other advisors,
18 including Cantilo & Bennett, to discuss our issues with the
19 transaction.

20 MR. MITCHELL: With apologies because I don't have
21 extra copies, I'd like to put up on the ambo Exhibit 106,
22 which bears upon this subject.

23 Q (BY MR. MITCHELL) Do you recognize Exhibit E-106 as an
24 e-mail from Mr. Taktajian to Mr. Hamje upon which you and
25 Mr. Alderson Smith are copied, along with Mr. Lardo?

1 A Yes.

2 Q Did Mr. Taktajian tell you at the time of this message or
3 later that his concept of what is required for approval under
4 applicable law was based upon an assumption rather than an
5 analysis?

6 A I'm not sure I understand the question.

7 Q Did Mr. Taktajian advise you or advise others in your
8 presence, Mr. Koplovitz, that his notion of what was required
9 under the law for this transaction was based upon an
10 assumption?

11 A I don't believe I had a conversation with him about that
12 topic.

13 Q At the time that Blackstone generated its issues list in
14 early December of 2003 and, indeed, until January 2004, the
15 framework for the discussions with Premera was a single
16 foundation shareholder; is that not true?

17 A There had been discussions about two foundations versus one
18 foundation. And I think while people were sorting out
19 whether it should be one foundation or two foundations, we
20 were moving along a track of deal documents, assuming one
21 foundation.

22 Q It was in January of this year, was it not, Mr. Koplovitz,
23 that the state's consultants informed Premera that they would
24 insist upon having two foundations?

25 A I don't remember the exact date, but it was either late

1 December or early January.

2 Q And it was only after Premera had accepted the principle of
3 having two foundation shareholders that the consultants
4 informed Premera of their desire to double up on their rights
5 previously under discussion, namely a designated member on
6 the New Premera board, a five percent minus one block of
7 shares outside the voting trust agreement, and separate
8 divestiture schedules; is that not true?

9 A I think you're right. I think that was the first time those
10 topics were raised, although I would add that we hadn't
11 discussed some of these issues with Alaska. And it's very
12 possible these issues would have come up under one foundation
13 as we tried to work through the mechanics with Alaska of
14 having one foundation and basically having Washington and
15 Alaska sharing these rights. So we really - I think the two
16 foundations crystallized people's thinking and maybe got us
17 to a conclusion faster. We might have had some of the same
18 issues under one foundation.

19 Q Now, that development in - earlier this year had the effect
20 of doubling up the number of issues requiring the blessing of
21 the Blue Cross/Blue Shield Association, did it not?

22 A I think there were a few issues where it did result in a
23 doubling up, yes.

24 Q Maybe I should be more specific because I'm multiplying by
25 three at this point. It is your understanding, is it not,

1 Mr. Koplovitz, that the question of the 50 percent threshold
2 for free voting on change in control proposals, the term of
3 the designated board members and the overall divestiture
4 schedule are already BCBSA issues; right?

5 A Yes. It's my understanding that the Blue Cross has an issue
6 with our positions.

7 Q And then after the two foundation proposal was accepted,
8 there were three more issues that had to be dealt with,
9 namely the question of whether there would be one or two
10 designated members on the New Premera board, a question of
11 whether there would be one or two five percent blocks of
12 shares outside the voting trust, and the issue of whether or
13 not there would be a joint or a separate divestiture
14 schedule; right?

15 A That's right. There were more issues once we went to the two
16 foundation that the Blue Cross had a point of view on.

17 Q Now, you've heard testimony about the efforts that Mr. Barlow
18 and legal counsel for Premera made before the PPF&C committee
19 of the association to address those duplicate foundation
20 issues; correct?

21 A Yes.

22 Q And you understand as well what the testimony has been about
23 the association's issues on all six of the issues I ticked
24 off, have you not?

25 A I have heard the - Premera's view on what the Blue Cross's

1 position is on those issues.

2 Q And you understand, do you not, that the association has
3 refused to grant an exception to its licensure requirements
4 to accommodate any of those issues save the appointment of
5 two designated board members?

6 A That's my understanding.

7 Q Mr. Koplovitz, you would agree, would you not, that the Blue
8 marks are of great value to in company and to its
9 subscribers?

10 A Yes. I would agree that the Blue mark has value for Premera.

11 Q And you would agree as well, would you not, Mr. Koplovitz,
12 that on the other side of the ledger, it would be difficult,
13 if not impossible, to quantify the value of having say a
14 second five percent block of shares outside the voting trust
15 agreement or a different threshold for free voting on a
16 change in control?

17 A I'm sorry. Could you repeat the question.

18 Q Certainly. You would find it difficult, if not impossible,
19 would you not, Mr. Koplovitz, to quantify the value to the
20 foundation of having let's say a second block of shares
21 outside the voting trust or a different threshold for free
22 voting on a change of control?

23 A It is difficult to value those - what those provisions are
24 worth.

25 Q So my question to you, Mr. Koplovitz, in this context is

1 this: Would it be your advice to the Commissioner in this
2 proceeding that he should, in effect, play chicken with the
3 BCBSA over these issues?

4 A Again, I don't see it that way.

5 Q Is that a yes or a no, Mr. Koplovitz?

6 A I'm sorry. Could you repeat the question.

7 Q Sure. Would it be your advice to the Commissioner in this
8 proceeding that he should, in effect, play chicken with the
9 BCBSA over the issues that implicate the Blue license of
10 Premera?

11 A No. I think what I testified to earlier is how we looked at
12 the fairness determination. And in our looking at the
13 fairness determination, these are issues that we believe are
14 important. So I do not view it as playing chicken. What
15 we're doing is we're trying to outline for the Commissioners
16 issues that we believe are important to protect the value of
17 the foundation's stake.

18 Q So I think your answer may have anticipated my next question,
19 which is this, Mr. Koplovitz: When you looked at these
20 issues of fairness, you were not considering the impact
21 potentially upon the company or its subscribers, but merely
22 the impact upon the foundation; is that not true?

23 A We were focusing on these issues from the foundation's
24 perspective. But protecting the value to the foundation is
25 also important from the public's perspective because the

1 value of that stock ultimately will go to public initiatives.

2 Q In that calculus, Mr. Koplovitz, did you consider the
3 potential impact upon the subscribers of Premera?

4 A I believe our opinion is to the public.

5 Q The public as an undifferentiated whole interested in the
6 foundation?

7 A Well, I think the foundation might be an embodiment of the
8 public, as they are getting the stock and they are using that
9 stock to, you know, meet public needs for unmet healthcare.

10 Q My question to you, sir, is whether in evaluating fairness,
11 as you had described it, you have considered the issue of the
12 impact upon Premera's subscribers?

13 A Well, as I mentioned to you earlier, we did look at the
14 business case analysis and we did look at some of the risks
15 of the conversion. And I think in that analysis, we did
16 think about the subscribers. We did, you know, understand
17 that from a risk-based capital, access to capital, and maybe
18 some additional capital would be a good thing for the company
19 and its subscribers. We also did think about the risks of
20 converting. But I do think within this particular issue of
21 the value, the fair value, that's going to the foundation, we
22 really were more focused on the foundation in that analysis.

23 Q So if I understand you correctly, Mr. Koplovitz, when you
24 examined the business case for conversion, you were thinking
25 about the benefits and risks to the company and to its

1 members. But when you turned to examine the terms of the
2 transaction, you were focused solely upon protecting the
3 interests of the foundation as you saw them. Is that not
4 true?

5 A I think we are going upon advice of the legal experts. And
6 the legal experts have told us that one of the requirements
7 is that the foundation receive fair market value for the
8 assets. And within that calculus is where we took into
9 account the potential impact of these restrictions, the
10 potential impact of dilution and, as I said earlier, the
11 procedures opinion and the properly marketed IPO concept. So
12 I think based on the legal advice we've been given - and we
13 are not lawyers; we are investment bankers - we have been
14 told that this transaction requires fair market value to be
15 distributed to the foundation at the closing.

16 Q Did you receive that instruction from Mr. Cantilo?

17 A We received it from our client and from Cantilo & Bennett,
18 the legal advisors and the AG offices. We had discussions -
19 conference calls with them on this issue. And I think the
20 feedback we were given from the - from each of those . . .
21 And I don't remember exactly who it came from. But we did
22 have - all of those parties were on the conference calls.
23 And that was the feedback we were given in terms of how we
24 should analyze this.

25 Q Did the Attorney General's office or the OIC Staff or

1 Cantilo & Bennett ever tell you the basis for their judgment
2 that this was the issue you should be examining?

3 A I think we relied on their judgment.

4 Q My question to you is: Did they ever explain to you why that
5 was their judgment?

6 A They might have explained it to me, but I can't recall.

7 Q And I believe you've already testified that they didn't
8 explain to you it was based upon an assumption. Is that
9 correct?

10 A Yeah. I can't recall what it was based on.

11 Q Now, there's been some suggestion in this case,
12 Mr. Koplovitz, that the foundations might be disadvantaged if
13 there was a requirement that their holdings be no more than
14 80 percent of the total shareholdings at the end of one year
15 post-IPO. My question to you, sir, is this: Cannot the
16 issue of required no less than - I'm sorry - no more than
17 80 percent shareholdings at the end of one year be
18 accomplished by an initial public offering that amounts to
19 20 percent of the shares of the company?

20 A I do agree with you that if the IPO is greater than
21 20 percent, the foundation would own less than 80 percent.
22 And I think that's a possibility. The problem --

23 Q And my follow-on question to you, Mr. Koplovitz, is that that
24 would be true even if all of the shares were offered
25 initially by the company. Or it could be true if some of the

1 shares were offered by the foundation and some of them by the
2 company, but totaling 20 percent of the total. Is that not
3 true?

4 A Yes. That - that is a possibility.

5 Q And insofar as there might be some difficulty associated with
6 selling additional shares after the IPO, that difficulty
7 arises because of 180-day blackout period that was included
8 at the consultant's request. Is that not true?

9 A We think that investors will want to see a 180-day blackout
10 period. We think it is very customary. So it did come at
11 our request. But we think it's for the benefit not only of
12 the foundation, but also for the company.

13 Q Now, there's been some testimony in this case about public
14 float. And I believe you mentioned that as well in your
15 direct testimony, Mr. Koplovitz. If I recall correctly, you
16 said that on average, the minimum public float for these
17 kinds of transactions has been in the neighborhood of
18 20 percent. Is that right?

19 A I actually said that the average float had been 20, and there
20 had been some that had been smaller than 20.

21 Q I beg your pardon and I appreciate the clarification. You
22 heard Mr. Kinkead's testimony that a minimum public float, in
23 his judgment, would be in the neighborhood of \$100 million.
24 Do you recall that testimony?

25 A I don't recall that testimony. But if you tell me he said

1 it, I'll take your word for it.

2 Q Would it be consistent with your judgment, Mr. Koplovitz,
3 that from the standpoint of establishing a robust public
4 market in the stock, that a float in the neighborhood of
5 \$100 million, \$150 million, would be adequate for the
6 purpose?

7 A This is a determination that I feel we would probably want to
8 make a lot closer to the IPO date. It is possible that
9 \$100 million could be the right size float. Could be a
10 little bit smaller. Could be larger. But again, I think
11 this is a decision that would need to be made much closer to
12 the IPO date.

13 Q Do you agree, Mr. Koplovitz, that having a minimum sufficient
14 public float is important in terms of the ability of the
15 foundation effectively to monetize the value of its stock
16 post-IPO?

17 A I believe a minimum public float is important.

18 Q And is it also your understanding, Mr. Koplovitz, that
19 requiring that the foundation's shareholdings be no more than
20 80 percent after one year is consistent with the objective of
21 obtaining sufficient public float in the stock?

22 A Could you repeat the question.

23 Q Sure. Is it your understanding as well that requiring that
24 the foundation's share of the stock in total be no more than
25 80 percent after one year is consistent with the objective of

1 having a sufficient public float in the stock to allow
2 orderly divestiture of the shares and realization of value to
3 the foundations?

4 A I think it's possible. But I would say that there is a
5 scenario where the initial public float is less than
6 20 percent and you could still have an orderly market in the
7 shares. And I believe WellChoice was 18 percent. And so
8 it's possible you could have a public float of 15 or
9 16 percent. And under that scenario, the foundation would
10 still need to sell more stock if it needed to get below 80.

11 Q I assume though that as you approach the actual IPO date and
12 you are discussing this with the underwriters and so forth,
13 that you can manage to achieve both a sufficient public float
14 and assure yourself that you're going to leave no more than
15 80 percent of the shareholdings into the foundation, can you
16 not?

17 A Difficult to say so far in advance of the IPO. I mean there
18 is a possibility that the right public float, given the
19 market conditions, will be less than 20 percent. It won't be
20 a lot less. You know. But it could be 15 percent. And
21 under that scenario, you know, the foundation would still
22 need to sell more stock to meet the one-year deadline.

23 Q I want to switch topics, if I might, and talk to you about
24 the equity compensation plan. A number of the issues that
25 were outlined by Blackstone in early December of last year

1 related to the equity compensation plan, did they not?

2 A That's correct.

3 Q And it is your testimony, is it not, that every one of those
4 issues has now been resolved to Blackstone's satisfaction?

5 A Yeah. I believe there was one issue remaining in our amended
6 report. And I believe we have resolved that in the pre-filed
7 testimony.

8 Q There was one point in your testimony, Mr. Koplovitz, you
9 were talking about the - I'm sorry - the bring-down opinion
10 that you anticipate doing closer to the IPO. Do you recall
11 that testimony?

12 A Yes.

13 Q And I believe you said that in terms of the bring-down
14 certificate that you were seeking from Premera, that there
15 really were only two issues at - two matters still in
16 dispute. One was whether or not the required threshold - the
17 threshold for reporting a change in the RBC should be
18 25 points versus 50 points. And the other was a change in
19 recommendations by advisors to the company. Is that right?

20 A That's correct.

21 Q Now, you've had an opportunity to look at the RBC figures for
22 the company over the past few years, have you not?

23 A Yes.

24 Q And would you not agree with me that an RBC change of 25
25 points is within normal annual fluctuation for the plan?

1 A Yes. I think 25 points is not out of the ordinary. They
2 were 406 last year. They're 433 this year. So that's a
3 little more than 25 points. So it's not out of the ordinary.

4 Q So does it strike you as being unreasonable that a 50 point
5 shift would be more likely to be material than a 25 point
6 shift?

7 A I think what we're asking is for the company to disclose it
8 to us. And I don't think it's an unreasonable request.

9 Q With respect to the proposal you've made about changes in
10 recommendations by legal counsel, I believe you testified
11 during your direct examination that you're actually looking
12 for legal opinions; is that right?

13 A I think that's what we're focused on. Yes.

14 Q And I think that's important, because in your supplemental
15 report, you talked about a change in any recommendation by
16 any lawyer to the company. And you recognize, do you not,
17 that that raises questions of attorney-client privilege?

18 A Yeah. I think we were more thinking of formal, you know,
19 presentations or formal opinions as opposed to just kind of
20 daily conversations. I don't think that's what we were
21 looking for.

22 Q So insofar as the Commissioner might be inclined to take your
23 suggestion for a change in this particular requirement, your
24 testimony is that he should focus on written opinions, not on
25 the advice of legal advisors?

1 A The written opinions or maybe written reports. I mean if
2 there's something that rises to the level that the lawyers
3 are going to actually write a report and present it to the
4 board, I mean I think that might be something that we would
5 also consider.

6 Q You testified, I believe, that you had a concern that there
7 be greater clarity in the plan permitting you to share
8 information with the Washington foundation as the IPO date
9 approaches. Do you recall that testimony?

10 A Yes.

11 Q And I believe you said that Premera had been silent on that
12 particular issue. Is that your testimony?

13 A I think my testimony is that the documents are unclear on
14 that issue.

15 MR. MITCHELL: May I approach?

16 JUDGE FINKLE: Yes.

17 Q (BY MR. MITCHELL) Mr. Koplovitz, I've just handed you a copy
18 of Mr. Marquardt's pre-filed direct testimony, Exhibit P-58.
19 And direct your attention to a passage on page 33 on that
20 document. Could you read that passage to yourself in the
21 middle of the page.

22 A (Witness complying.) Okay.

23 Q Mr. Marquardt has indicated, has he not, that Premera has no
24 objection to the financial advisor to the Commissioner
25 sharing its findings with the Washington foundation?

1 A Yeah. That's what it looks like.

2 Q So insofar as that might have been an issue, would you agree
3 with me, Mr. Koplovitz, that it really is not an issue
4 between the company and the OIC Staff's consultants?

5 A Yeah, assuming, you know, this is a binding commitment. Yes,
6 I think we would be okay with this.

7 Q And I think you indicated that - when we were last together,
8 Mr. Koplovitz, that a letter of consent would serve as well
9 as a formal change to the Amended Form A for this purpose,
10 did you not?

11 A I think a letter of consent would suffice.

12 Q I want to talk to you just a bit about the survival of the
13 voting trust agreement in the wake of loss of the Blue
14 Shield/Blue Cross marks, Mr. Koplovitz. My understanding is
15 that Blackstone believes that there's no reason to continue
16 the voting trust agreement if the Blue Shield/Blue license is
17 gone because in those circumstances, the requirements of the
18 association no longer apply. Is that Blackstone's position?

19 A I think, yes, our position is that those restrictions stem
20 from the Blue Cross/Blue Shield Association. And so if we
21 lose the mark, those restrictions should not apply, as they
22 did not apply in WellChoice when the mark went away.

23 Q And in making that judgment, Mr. Koplovitz, am I correct in
24 inferring from your earlier testimony that you were looking
25 at this solely from the perspective of the foundation and you

1 were not weighing the potential consequences to Premera's
2 subscribers?

3 A I think in looking at this issue, we were more focused on
4 protecting the value of the foundation stock at that point.

5 Q And I take it then that you would not presume to suggest to
6 the Commissioner that he should ignore the interests of the
7 subscribers when it comes to that particular question.

8 A Yeah. And I'm not sure I'm saying we were ignoring the issue
9 of the subscribers. I think we were focusing more on the
10 foundation and protecting the value of the foundation's
11 investment. Our sense is that if the company loses the Blue
12 mark - and it is a very remote possibility - it would
13 probably be a situation that was a negative situation. And
14 in that instance, we believe that the owners of the company,
15 which at that point would be the foundation, assuming that
16 they still owned more than 50 percent of the stock, should be
17 able to take the actions that are necessary to protect the
18 value of their investment, as the owner of any public company
19 would be able to do.

20 Q Would you agree with me, Mr. Koplovitz, that it's unlikely
21 that the directors of the foundations would have experience
22 or expertise in running an insurance company?

23 A No. But like any board --

24 Q I'm sorry. Is your answer no, you would not agree? You do
25 believe that they would have expertise in running an

1 insurance company?

2 A Could you repeat the question.

3 Q I think we were miscommunicating, which is why I interrupted
4 you. And I apologize. Do you believe, Mr. Koplovitz, that
5 the board of directors of the Alaska and Washington
6 foundations would consist of individuals with experience,
7 background and ability in leading a significant insurance
8 company? Or would they have other skills and abilities?

9 A It depends.

10 Q Would you agree with me, Mr. Koplovitz, that the latter is
11 more likely than the former?

12 A I'm not sure who is going to be on that board at this point,
13 so it's very difficult for me to tell you what skills they
14 would have.

15 Q Would you agree with me, Mr. Koplovitz, that members of
16 Premera's board and people with experience with Premera are
17 specifically barred from serving on that board?

18 A That is correct.

19 Q Now, when you began your testimony, Mr. Koplovitz, you
20 indicated that you had been involved in a number of
21 demutualization and conversion transactions and you ticked
22 off a number of them. Have you ever advised on a successful
23 conversion, Mr. Koplovitz?

24 A Yes.

25 Q Can you tell me when that happened.

1 A We advised on the conversion of MetLife. We advised on the
2 conversion of John Hancock. We advised on the conversion of
3 Prudential.

4 Q I'm sorry. Are those demutualization transactions?

5 A They're also called conversions.

6 Q I'm sorry. Let me ask my question with a little bit more
7 clarity. Have you advised on any successful conversions that
8 were not demutualizations?

9 A We've also advised on successful sponsored demutualizations.

10 Q I don't believe that was my question, Mr. Koplovitz. Have
11 you advised on any successful conversions from nonprofits
12 that were not demutualizations?

13 A No.

14 Q Is there a group in the nonprofit conversion context that
15 occupies the same position as the policy holders in a mutual
16 insurance company?

17 A Well, in a mutual insurance company, the policy holders are
18 the owners. In a not-for-profit, there really are no owners
19 per se. But the business is operated for the public benefit.
20 Or at least that's my understanding of it.

21 Q That's what you were informed, I take it, by the legal people
22 that you talked to.

23 A That's my understanding of it. I'm not sure - I'm not
24 exactly sure how I arrived at that understanding.

25 Q Is there a difference, Mr. Koplovitz, in the

1 dilution/accretion analysis that one would perform in a
2 demutualization transaction as compared with a nonprofit
3 conversion?

4 A Possibly.

5 Q In the instance of a demutualization, you have policy holders
6 who have real holdings in the company and whose holdings
7 might be diluted by the transaction, do you not?

8 A Typically in a demutualization, policy holders are getting
9 cashed out or many of the policy holders are getting cashed
10 out at the time of the demutualization.

11 Q And is it not a reasonable concern under those circumstances
12 that their interests not be inappropriately diluted?

13 A It is a concern that - whether or not they're diluted. But
14 they own a hundred percent of the company before the
15 transaction. And the money that's raised is usually used to
16 cash out policy holders. So it's really a shift of
17 ownership. There's very - I mean sometimes there's primary
18 proceeds being raised by the company which could dilute the
19 owners. But it's really policy holders selling. It's really
20 just selling shareholders.

21 Q In this instance, Mr. Koplovitz, is it not the case that
22 there are no selling shareholders, that the foundations will
23 be the initial shareholders in Premera?

24 A Well, that's a tricky question.

25 Q Can you try a yes or a no?

1 A I'm not sure if I can answer that with a yes or a no.

2 Q Would you agree with me, Mr. Koplovitz, that the foundations
3 will have nothing to sell on the public markets unless there
4 is a conversion and an IPO?

5 A I would agree that unless there is a conversion, the
6 foundations will not own the company and, thus, they will
7 have nothing to sell.

8 Q And so there's nothing to dilute at this point, is there, in
9 terms of the foundation's shareholdings? They will get what
10 they will get only after the conversion happens?

11 A I would look at it a little differently.

12 Q Let me ask you this Mr. Koplovitz: You've had the
13 opportunity over the last year and a half or more to examine
14 Premera in its management in some depth. I think you
15 testified earlier that Premera's management is one of the
16 assets that it would bring to the market, one of the reasons
17 it would be an attractive IPO candidate. Is that right?

18 A I did say that I thought they would be capable of running a
19 public company.

20 Q Do you have any reason to believe, Mr. Koplovitz, that the
21 management of Premera would not act reasonably and prudently
22 in applying the capital raised through an IPO?

23 A I'm not sure.

24 Q You testified, Mr. Koplovitz, that a 15 percent value
25 dilution, by your reckoning, would not be something you could

1 recommend as fair to the foundations. My question to you is:
2 What, if any, impact, if such a dilution were to occur, would
3 there be upon the subscribers of Premera or the
4 insurance-buying public?

5 A I'm not sure if there would be an impact on the subscribers.
6 And the only impact that there might be on the insurance
7 buying public is obviously if there's more money going to the
8 foundation, there's more money that can be put into the
9 system through charitable initiatives to help people that
10 don't have insurance. So I think it is related.

11 Q Is there a sense, Mr. Koplovitz, in which there might be a
12 trade-off in terms of providing more capital, more security,
13 to Premera's subscribers versus assuring the foundation that
14 it would not have more dilution, as you calculate that?

15 A Yes. I do agree that it is a trade-off between strengthening
16 the balance sheet and the RBC and maybe giving more comfort
17 to subscribers versus on the other hand diluting the
18 foundation. So I do believe yes, it is a trade-off.

19 Q Now, as I understand it, Mr. Koplovitz, the concerns that
20 Blackstone previously expressed about dilution have been
21 substantially allayed by the agreement to have a procedures
22 opinion as the IPO date approaches and at that time to look
23 at the uses of capital, the amounts that might be raised and
24 the proportions of such capital that would be contributed by
25 the company and by the foundations. Is that correct?

1 A Yes. We are - we believe that the provisions that would be
2 put into the plan related to sharing information with us and
3 allowing us to do a procedures opinion and a bring-down
4 opinion for now address that issue. Obviously we'll need to
5 revisit when we get closer to the IPO and we get the actual
6 data.

7 Q And do you understand from Mr. Marquardt's testimony and
8 otherwise, Mr. Koplovitz, that the business plan that Premera
9 will have for the use of the proceeds in the IPO will be
10 fully fleshed out at that stage?

11 A That is the testimony that Mr. Marquardt gave.

12 Q You testified in your direct examination, Mr. Koplovitz, that
13 equity was the most expensive form of capital because of the
14 fact that the equity shareholder occupies the bottom rung in
15 the capital structure. Do you recall that testimony?

16 A Yes.

17 Q In the course of your work on this matter, Mr. Koplovitz, you
18 examined in some detail the alternatives that might be
19 available to Premera to address its capital needs, did you
20 not?

21 A Yes.

22 Q And did you not conclude that none of those alternatives
23 would afford Premera the kind of capital flexibility, both in
24 the short run and particularly in the long run, as the
25 conversion proposal that's before the Commissioner?

1 A Yes. In terms of accessing capital on a repeated basis, I do
2 believe equity would give them the greatest flexibility.

3 Q And beyond that, equity also delivers an immediate impact to
4 the RBC, does it not, in a fashion that debt or similar kinds
5 of capital-raising alternatives would not?

6 A Well, surplus notes could give a boost to the RBC as well.
7 But equity does give a boost to the RBC. That is correct.

8 Q And with respect to surplus notes, I believe you concluded,
9 did you not, that they are not available and - likely
10 available to an entity that has the credit rating of Premera
11 and certainly not in the amounts contemplated, that Premera
12 hopes to raise here?

13 A Yes. We've concluded that surplus notes would not be
14 available in the amounts that equity would be available.

15 MR. MITCHELL: I have nothing further. Thank you,
16 Mr. Koplovitz.

17 THE WITNESS: You're welcome.

18 MS. McCULLOUGH: Mr. Koplovitz, hi. I'm Amy
19 McCullough. And I'm going to be asking you some questions on
20 behalf of the Alaska Intervenors.

21 THE WITNESS: Okay.

22 //

23 //

24 //

25 //

CROSS-EXAMINATION

BY MS. McCULLOUGH:

Q First, how many IPO's have you been involved in?

A Well, when I worked at Bear Stearns, I worked on several IPO's. Now I'm in the advisory business so we do not have a capital markets capability ourselves but we do - we have monitored several IPO's with - related to our regulatory work, as I was saying before, with our IPO procedures opinion. Also, our firm owns companies and we sometimes take those companies public.

Q Okay. Thank you. And in your opinion, how much will it cost to conduct Premera's IPO?

A Well, there would be the ongoing cost of the conversion, which I believe is around 30 million now. And I think that number will continue to go up. I don't know what the final number would be. There's also a spread that's paid to the underwriter in an IPO, and it's typically a percentage of the IPO proceeds. And depending on the size of the IPO and the underwriting syndicate, it could be six percent, something like that, of the IPO proceeds.

Q And you're familiar with Signal Hill Capital; is that right?

A Yes.

Q And they were assigned to perform an allocation analysis for the Alaska Division of Insurance; is that correct?

1 A That's correct.

2 MS. McCULLOUGH: Permission to approach the
3 witness.

4 JUDGE FINKLE: Yes.

5 MS. McCULLOUGH: And for counsel's purposes, I'm
6 going to be handing Mr. Koplovitz Intervenor's Exhibit I-162.

7 MR. MITCHELL: I'm sorry, counsel. Which exhibit?

8 MS. McCULLOUGH: I-162.

9 Q (BY MS. McCULLOUGH) And I'd like to direct your attention to
10 the last page of that exhibit, which is marked page 71.

11 A Okay.

12 Q And will you read for me out loud the bulleted sentence
13 there.

14 A "Based on the revised results, it is Signal Hill Capital's
15 view that the director should consider an allocation of New
16 Premera stock to the Alaska foundation in the proposed
17 conversion transaction in the range of 25.8 percent to 29.6
18 percent."

19 Q Thank you. And that would translate to a range of 70.4 to
20 74.2 percent for Washington; is that right?

21 A Yes.

22 Q Thank you. And if I could direct your attention now to
23 Exhibit S-6, which I believe is your March 30th, 2004 updated
24 discussion materials.

25 A Yes.

1 Q I'm just waiting for everybody to get it. And if you could
2 turn to page 1, to the fifth bullet on that page.

3 A Yes.

4 Q And there you state that the operating income and net income
5 metrics include several allocation of fixed costs and
6 therefore may be less reliable indicators of the allocation
7 of value; is that right?

8 A Yes.

9 Q And your conclusions in this regard rest in part on
10 PricewaterhouseCoopers' assessments of the allocation of
11 expenses; is that right?

12 A That's right.

13 Q So if PricewaterhouseCoopers' assessments were erroneous,
14 then your conclusions that rest on those assessments would
15 also be erroneous; is that right?

16 A Well, I think if that was the case, we would put more
17 emphasis --

18 Q Mr. Koplovitz, it's just yes or no, please.

19 A Oh, sorry. Could you repeat the question.

20 Q Certainly. If PricewaterhouseCoopers's assessments regarding
21 the allocation of expenses were erroneous, then your
22 conclusions that rest on those assessments would also be
23 erroneous; is that right?

24 A It's possible.

25 Q I'll take it that that's a yes?

1 A It was an it's possible actually.

2 Q Thank you. And to the best of your knowledge, Premera's
3 operating expense allocations have been audited by
4 regulators, including the OIC; is that right?

5 A I'm not aware of that.

6 Q Through your due diligence, you didn't research whether the
7 allocation of expenses have been audited?

8 A I did not look at that particular issue.

9 Q Okay. If I could direct your attention to page 7 of that
10 same report. On this page, you list a number of factors that
11 may affect the potential allocation of value between the
12 Washington and Alaska operations; is that right?

13 A That's correct.

14 Q And the first factor here relates to Premera Blue Cross
15 Alaska, which I'll refer to as PBC Alaska, being a
16 stand-alone entity; is that right?

17 A Not exactly.

18 Q The first bullet on - following the header there, does that
19 say, "As a stand-alone entity, PBC AK may lack economies of
20 scale"?

21 A Right. And I think my point is just that we were not saying
22 that it's a stand-alone entity. We were making a point that
23 it might lack scale relative to Washington.

24 Q Okay. PBC Alaska is not a stand-alone entity; is that right?

25 A No.

1 Q And to your knowledge, have the Alaska operations ever been
2 stand-alone?

3 A Not to my knowledge.

4 Q And to your knowledge, does Premera have any plans for PBC
5 Alaska to become a stand-alone entity?

6 A Not to my knowledge.

7 Q To your knowledge, does Premera have any plans to sell off
8 its Alaska operations?

9 A Not to my knowledge.

10 Q And do you have any reason to believe that Premera will not
11 treat the Washington and Alaska operations as one business in
12 the future?

13 A I don't have any reason to believe that.

14 Q Okay. Now, regarding your statement that - that PBC Alaska
15 may lack economies of scale, isn't it true that the
16 Washington operations would also lack economies of scale to
17 do its own IPO without Alaska?

18 A I think Washington without Alaska could complete an IPO.

19 Q Could it raise the amount of capital that Premera wants to
20 raise through this IPO?

21 A I'm not sure what you're asking me.

22 Q If Premera conducted an IPO of just its Washington
23 operations, do you think that it would be able to generate
24 \$150 million in new capital?

25 A It's possible.

1 Q It's possible. Is it likely? And again, this is based on
2 your experience and your knowledge.

3 A Well, I'm not advocating \$150 million IPO for the whole
4 company, so I certainly wouldn't be advocating \$150 million
5 IPO for Washington only.

6 Q My question was: Is it likely that they could?

7 A Yes. They would just have to sell a bigger piece of the
8 company.

9 Q Okay. There are a number of profitable health plans that are
10 about the size of the Alaska operations; isn't that correct?

11 A I haven't studied that.

12 Q Does that mean that you don't know?

13 A Yes.

14 Q And your report doesn't consider whether Alaska could
15 outsource the same services it receives from Premera and
16 whether that would cost less for Alaska, does it?

17 A I haven't studied that.

18 Q How did you arrive at the conclusion that Alaska lacks
19 economies of scale?

20 A I think it was a relative determination and we were looking
21 at Alaska relative to Washington. And as I testified to
22 earlier, I think our view is that there is some correlation
23 between scale and the valuation multiple that a stock would
24 get. We have looked at this in the past. And there
25 basically is correlations.

1 Basically, in health insurance, larger companies are
2 more efficient. They have lower administrative cost ratios.
3 And typically the market rewards them for that efficiency.

4 Q Does Premera's Washington operations have lower
5 administrative costs than its Alaska operations?

6 A Well, again, I think it's a function of the allocation of
7 expenses, so I think it's difficult to say.

8 Q Does that mean you don't know whether it does or not?

9 A Yes.

10 Q And your report doesn't provide a valuation of Alaska or
11 Washington as stand-alone entities, does it?

12 A No. We did not do a stand-alone valuation of either.

13 Q And if you could look at the third square bullet on that
14 page. You state, "Most contracting in Alaska is on a
15 fee-for-service basis with some PPO business, as managed care
16 has never really gained widespread acceptance." Is that
17 right?

18 A Yes.

19 Q Premera's fee-for-service business in Alaska is profitable;
20 is that correct?

21 A I believe it is.

22 Q And Premera has experienced some major losses in its managed
23 care products through its Washington operations; is that
24 correct?

25 A Some products have lost money, yes.

1 Q Some of them have lost a lot of money; is that right?

2 A What do you mean by a lot?

3 Q Well, actually let me ask you. What would you define as a
4 lot of money?

5 A It depends on the context.

6 Q In the interest of time, I'll move on. Does it matter what
7 the business is, whether it's fee-for-service or managed
8 care, as long as the business is profitable?

9 A I think profitability is important. I think growth is
10 important. I think scale is important. But I do think
11 people look at business mix as well.

12 Q So then is your answer that it does matter?

13 A It's a factor -- I'm sorry. I think it's a factor that
14 people might consider in making a valuation.

15 Q But bottom line, an investor wants to make sure that whatever
16 lines of business Premera has, they're profitable; right?

17 A I think profitability and growth and scale are probably more
18 important. And maybe business mix might be a secondary
19 consideration. But it might - people might - it might color
20 how people think about those other factors.

21 Q Okay. Isn't it true that the Alaska operations provided
22 Premera's only nonprofit book net income in 1997?

23 A I don't believe our analysis went back that far.

24 Q So you don't know whether it did or not?

25 A I don't - I don't recall.

1 Q Would it surprise you if that was the case?

2 A That was a long time ago.

3 Q So would it surprise you if that was the case?

4 A It's possible.

5 Q If you could look at the fourth square bullet on that same
6 page. You've listed Premera's expected growth rate in
7 Washington as an additional factor weighing in favor of
8 Washington; is that right?

9 A Yes.

10 Q Would it be fair to say that growth rate would only generate
11 a premium if it's a profitable growth rate?

12 A I'm not sure what you mean by a profitable growth rate.

13 Q Well, if Premera grows its business but that growth does
14 damage to its financial condition - I'm sorry - or doesn't
15 yield a profit, then it wouldn't command a premium; isn't
16 that right?

17 A I think we're focusing on the growth and profitability.
18 We're not focusing on the growth and revenues. We're
19 actually focusing on the growth in operating profit, net
20 income, underwriting margin.

21 Q Right. So there would have to be growth in profitability for
22 this to be a premium; is that right?

23 A That's correct.

24 Q And in your August 1st, 2003 report, which I believe is
25 S-5 . . . And again, it's the fourth bullet on that page.

1 A I'm sorry. Which page?

2 Q I'm sorry. Page 5. And there you cite to the Microsoft
3 account as being an example of the company's growth rate in
4 Washington; is that right?

5 A I think what we're citing is the Microsoft account as the
6 company's ability to get national accounts and service
7 national accounts through the Blue card program.

8 Q And to grow its operations; is that right?

9 A I think we are using the Microsoft example as a high profile
10 account that they won recently.

11 Q As an example of its ability to grow in western Washington;
12 is that right?

13 A Yes. I believe we said, yes, the company believes it can
14 grow its operations and market share in western Washington,
15 and then we cite Microsoft as an example there. That's
16 correct.

17 Q Right. Thank you. Premera has been losing money on the
18 Microsoft account; is that correct?

19 A Depends on how you look at it.

20 Q Has Premera lost money on the Microsoft account?

21 A On a totally allocated cost basis or on a contribution basis?

22 Q Well, let me ask you: Do you remember that your deposition
23 was taken March 17th of this year?

24 A I do.

25 Q And do you remember that I asked you a number of questions

1 during that deposition?

2 A I do.

3 Q And do you remember I asked you that exact question and that
4 your answer was yes?

5 A And I guess now I'm just asking you to clarify the question
6 because I've maybe thought about it a little more.

7 Q Well, how about this: How about if you clarify what you
8 meant in your deposition when you said they had been losing
9 money on the Microsoft account?

10 A Well, let me explain.

11 Q Sure.

12 A I think they are losing money at the bottom line on the
13 Microsoft account. But it is an ASO account. And it
14 contributes profit on a direct cost basis. But then there
15 are allocated costs to Microsoft and it loses money. If you
16 get rid of the Microsoft account, you have all these fixed
17 costs that you need to allocate somewhere else in the
18 company. So while it does lose money on an allocated,
19 fully-loaded basis, it does contribute - it does have a
20 contribution to profit before you allocate overhead and it
21 absorbs a lot of fixed overhead.

22 Q So it's - the Microsoft account still contributes?

23 A On a kind of a contribution basis before allocating fixed
24 overhead, it does contribute profit. But after you allocate
25 fixed overhead, it does not. But if you get rid of the

1 Microsoft account, you would have to allocate that overhead
2 someplace else. That's my point.

3 Q And you excluded the Microsoft account statement from your
4 final report; is that correct?

5 A Yeah. And I think the reason for that --

6 Q It's just yes or no.

7 A Oh. Yes, we did exclude it.

8 Q And these valuation considerations, these are qualitative
9 factors; is that right?

10 A That's correct.

11 Q And you did not quantify these qualitative factors; is that
12 right?

13 A Yes. They're qualitative factors.

14 Q And what portion of your allocation recommendation, the range
15 that you developed, which I believe is 83 to 89 percent, do
16 these factors constitute?

17 A They helped us to come up with the 83 to 89 percent. After
18 looking at the data, we took into account the qualitative
19 factors to formulate a range.

20 Q What would the range be if you had excluded these valuation
21 considerations?

22 A I don't know the answer to that.

23 Q Why is that?

24 A We haven't done that analysis.

25 Q So you didn't assign these any specific percentage points to

1 include in the range; is that right?

2 A No. They're qualitative factors.

3 Q Is it fair to say when assessing the value of each state's
4 operations, projected growth is an important factor to
5 consider?

6 A Yes.

7 Q And would it be fair to say that historic stability is also
8 an important factor to consider?

9 A What do you mean by historic stability?

10 Q Well, let me ask you this: You took a public market
11 evaluation approach; is that right?

12 A No. I think we took more of a contribution - what each side
13 is contributing to the party approach.

14 Q You just did a straight what each - you just did a straight
15 contribution analysis? Is that your testimony?

16 A We looked at the contributions and then we assessed the
17 qualitative factors. And I think my testimony was that in
18 thinking about these qualitative factors, we thought about
19 growth, scale and other items that would typically lead to a
20 higher valuation for one set of earnings versus another set
21 of earnings.

22 Q Because that's what an investor would consider; is that
23 right?

24 A Yes. I think that's a correct statement.

25 Q So in your opinion, do you think that an investor would want

1 to know whether the company has been volatile historically
2 speaking?

3 A They - they would look at historical statements.

4 Q Okay. In arriving at your allocation recommendation, you
5 relied on historical data from 2000 to 2002; is that right?

6 A I believe that's correct.

7 Q And you didn't include historical data from 1997 to 1999; is
8 that right?

9 A Yes.

10 Q And looking at prospective data, you included data in your
11 final report from 2003 to 2006; is that right?

12 A Yes.

13 Q And in your August 1st, 2003 report, you included projected
14 data from 2004 to 2007; is that correct?

15 A Yes.

16 Q But your final report doesn't include projected data from
17 2007; is that right?

18 A Correct.

19 Q Yet your final allocation recommendation range did not
20 change; is that right?

21 A That's correct.

22 Q If you'll hold on just for one moment. I have just two more
23 questions and they're not about allocation. Nothing
24 prohibits Blackstone from performing a valuation on Premera's
25 - I'm sorry - on Premera now; is that right?

1 A No, nothing prohibits us from doing that.

2 Q And Blackstone was involved in the CareFirst proposed
3 conversion; is that right?

4 A That's correct.

5 Q And was Blackstone responsible for conducting a valuation
6 analysis in that case?

7 A Yes.

8 Q And you were able to perform the valuation analysis prior to
9 a decision on the conversion being made; is that right?

10 A That's correct.

11 MS. McCULLOUGH: Thank you. No further questions.

12

13 REDIRECT EXAMINATION

14

15 BY MS. deLEON:

16 Q Does Premera need to convert to raise their RBC?

17 A Not necessarily. Their RBC has gone up in the last year, and
18 they are still not-for-profit.

19 Q You talked about equity being the most expensive form of
20 capital. In your due diligence, did you look at other
21 alternatives that might be available besides the surplus
22 notes?

23 A Yes, we did.

24 Q Did you - could you explain a couple of those.

25 A Well, I think the first would be internally-generated cash

1 flows. And while, you know, that seems to be a source, there
2 does seem to be internally-generated cash flows in the
3 projection, you know, it's difficult to increase your RBC by
4 a significant amount through internally-generated cash flows,
5 especially if you're taking on a lot of new business. We
6 looked at a sale lease backhold. The company already
7 utilizes that form of raising capital. And it's not really
8 clear that they could do it a lot more than they're already
9 doing it.

10 Q What about a sale to say Anthem?

11 A We did analyze a sale to Anthem.

12 Q And what was your opinion regarding that?

13 A Particularly Anthem? Or just a sale?

14 Q Just a sale in general.

15 A Well, there are some merits to a sale. A sale could
16 obviously solve the capital problem. If the company sold to
17 someone with greater financial resources and scale, that
18 obviously could be a very good source of capital. A sale
19 could also give the company a lot more scale and possibly
20 enhance efficiencies and also enhance the ability to serve
21 national accounts.

22 There's also - in a sale transaction, it's possible
23 that shareholders can get a premium. Typically when one
24 company buys another company, there's a control premium, and
25 so shareholders will get a premium to public market

1 valuations, versus in an IPO, shareholders sell their stock
2 at an IPO discount. Obviously they don't sell the whole
3 company. They just sell a little piece in an IPO.

4 But again, I think Premera management has stated that
5 independence - independent management is very important to
6 their business. And that's not something we really analyzed.
7 Again, I think we were told in our work that we could rely on
8 an IPO as a way to determine fair market value and we didn't
9 need to second guess the board.

10 Q Do you have any indication that Premera's condition is going
11 to worsen in the future, their financial condition?

12 A No.

13 Q The divestiture schedule that requires the 80 percent - to
14 reach 80 percent in the first year, you said that was not in
15 the WellChoice deal?

16 A That's correct. WellChoice did have a provision, I believe,
17 where they had to sell at least 20 percent in the IPO. So
18 maybe it would be unnecessary in WellChoice.

19 Q Do you know whether this 80 percent requirement came from
20 Premera or the Blue Cross/Blue Shield Association?

21 A I believe Premera said they would take it out if the Blue
22 Cross/Blue Shield would agree to it.

23 Q Do you know, in your own personal opinion, whether the
24 members of the Premera Blue Cross board have any experience
25 running a health carrier prior to coming to the board?

1 A I can't recall.

2 Q And to the best of your recollection, did the OIC Staff or -
3 the OIC Staff's consultants first approach Premera about two
4 foundations as early as February of 2003?

5 A Yes. As I said, there had been some discussions early on.
6 And then we had proceeded with the one foundation track while
7 - you know, with the documents while we still explored the
8 issue. So I think it had been raised, you know, well in
9 advance. But there hadn't been a final determination. It
10 was something that we were still studying. So I do believe
11 that's true. It was raised earlier, in February of '03. I
12 don't know if that's the exact date, but something like that.

13 MS. deLEON: Thank you. No questions.

14

15 RECROSS-EXAMINATION

16

17 BY MR. MITCHELL:

18 Q Mr. Koplovitz, let me pick up on a couple of questions that
19 Ms. deLeon asked you. You said - you said I think, in
20 response to a question she posed to you, whether you had
21 reason to believe that Premera's financial condition might
22 worsen. You evaluated, did you not, Mr. Koplovitz, the four
23 scenarios that Mr. Marquardt described in his testimony
24 yesterday?

25 A We did look at those scenarios.

1 Q And you determined, as Mr. Marquardt testified as well, that
2 any one of those scenarios would knock Premera below the
3 early warning level of RBC. Is that not true?

4 A That's correct.

5 Q Ms. deLeon asked you whether Premera needed to convert to
6 raise its RBC. And you said no, citing the 27 point increase
7 in 2003 over 2002. Would you not agree with me,
8 Mr. Koplovitz, that in order to boost Premera's RBC to the
9 minimum 500 RBC level recommended by Ms. Novak, much less to
10 the 500 to 600 RBC range that Mr. Marquardt has testified is
11 Premera's goal, that conversion is necessary?

12 A There was a couple of parts in that question. One was
13 whether they get to 500 percent without converting. The
14 other was whether they get to 500 to 600 percent without
15 converting. Could you maybe be more specific in terms of
16 which one?

17 Q Let me ask you the point that I think Mr. Marquardt made,
18 which is that Premera's goal is to get to an RBC level
19 between 500 and 600 percent. Would you not agree with me,
20 Mr. Koplovitz, that the only way that Premera can reasonably
21 do that while remaining a locally-owned-and-operated company
22 would be to pursue a conversion, within the foreseeable
23 future at least?

24 A I wouldn't say that it's impossible to get to 500 without a
25 conversion. Obviously as we've looked at downside cases

1 there could be surprises on the upside. You know. Premera
2 could have better than expected results or better than
3 expected performance. So I wouldn't say it's impossible.
4 But I would say of the information that we've reviewed, we
5 never saw a forecast where they got to 500 percent without -
6 you know, in the base case.

7 Q Ms. deLeon asked you about the potential of a sale to Anthem,
8 which I believe is a purely hypothetical possibility at this
9 point, and asked whether that would not raise capital. It
10 certainly wouldn't raise any capital for Premera, would it?
11 Premera would disappear in that scenario, would it not?

12 A Well, Premera could still be a division within a larger
13 company.

14 Q I think you testified earlier, Mr. Koplovitz, that conversion
15 is not a, quote, "absolute necessity," closed quote. Is it
16 your understanding that under the provisions of the Holding
17 Company Act, Premera is obliged to demonstrate that
18 conversion is an absolute necessity?

19 A I'm not sure what it says under the Holding Company Act.

20 Q Would you not agree with me and, more importantly, the
21 Premera board, Mr. Koplovitz, that it is prudent for Premera
22 to pursue the course of conduct - course of action that it
23 has chosen?

24 A And I think as I've testified, I think we believe that
25 gaining access to capital and enhancing financial flexibility

1 is a very positive thing.

2 Q I want to go briefly to the question of allocation, which was
3 explored by Ms. McCullough. Do you think that the states of
4 Alaska and Washington would still be discussing the
5 allocation of the proceeds of this conversion between
6 themselves if Premera wasn't paying both sides' consultants
7 to pursue the matter?

8 A I could speak from my own perspective. I can't really speak
9 for the other consultants.

10 Q What is your perspective on that question, Mr. Koplovitz?

11 A My perspective is we're on a monthly retainer. So the less
12 we have to do, it's actually a good thing. So for them
13 having us do this, this is just extra work that we're doing
14 for our retainer. So for us, it's not an incentive to work
15 more. There's an incentive to be efficient and get our work
16 done as quickly as possible.

17 Q My understanding, Mr. Koplovitz - correct me if I'm wrong -
18 is that Blackstone has billed Premera in excess of \$5 million
19 for its work on this matter to date. Is that consistent with
20 your understanding?

21 A I do not know the exact figures that we've billed.

22 Q Would you agree with me, Mr. Koplovitz, that resolving this
23 question sooner rather than later would stop the clock at
24 least on this dispute?

25 A I'm not sure what you mean by stop the clock on this dispute.

1 I think everybody is trying to resolve this.

2 Q Do you know what Premera initially proposed by way of the
3 split between Washington and Alaska, Mr. Koplovitz?

4 A It's my understanding that there was a figure of 88 percent
5 for Washington and 12 for Alaska.

6 Q How long ago was that?

7 A I believe it was either in the original Form A filing or an
8 exhibit to the original Form A filing.

9 Q And after all of your work, where did you come out?

10 A 83 percent to 89 percent.

11 MR. MITCHELL: Nothing further.

12

13 RECROSS-EXAMINATION

14

15 BY MS. McCULLOUGH:

16 Q Mr. Koplovitz, when you were in the process of conducting
17 your allocation analysis, did you have to get data from
18 Premera?

19 A Yes.

20 Q And how long did it take you to get all of the data that you
21 deemed necessary to complete your analysis?

22 A The original analysis or the updated analysis?

23 Q Both.

24 A Well, I think we were looking at the data for several
25 purposes. I do remember it did take a long time to get the

1 data in the exact format we wanted it, split out by state and
2 with everything allocated. I don't remember the exact
3 timeline but it was a fairly lengthy process.

4 Q And if Premera had conducted its own allocation analysis and
5 provided you with that final data as well as the backup data,
6 would that have made your job easier?

7 A I'm sorry. I didn't understand the question.

8 Q If Premera had provided - if Premera had conducted its own
9 allocation analysis and had written a report about that, you
10 know, analysis, and had provided you the underlying data that
11 supported that analysis, would that have made your job
12 easier?

13 A I think it would have. I think it could have started as a
14 starting point for the discussions.

15 Q And it probably would have made the Alaska consultants' job
16 easier as well; is that right?

17 A I would imagine so.

18 MS. McCULLOUGH: Thank you. No further questions.

19 MS. deLEON: No further questions.

20 MR. MITCHELL: One question only, Mr. Koplovitz.
21 Is it not the case that the states advised Premera to stay
22 out of the discussions over allocation that they were
23 conducting between themselves?

24 THE WITNESS: I don't recall if the states advised
25 Premera or if there was an agreement. I don't remember how

1 that came about. But the states were trying to work it out.
2 I just don't remember the origin of that.

3 MR. MITCHELL: Nothing further. Thank you.

4 MR. KREIDLER: Mr. Koplovitz, there's just a
5 couple of quick questions I had relative to the IPO and the
6 voting trust agreements, first the IPO.

7
8 EXAMINATION

9
10 BY COMMISSIONER KREIDLER:

11 Q If . . . And I presume that there would be designated
12 purposes that Premera would have for an IPO. But if there
13 weren't and there was time, what would be the impact if, in
14 effect, the IPO were the existing stock that was in the
15 foundations that was let's say maybe the 20 percent that they
16 needed to divest in the first year was essentially the IPO
17 stand-alone, free of an IPO from Premera itself? What would
18 be the impact of that?

19 A It's certainly a possibility. I think there is this IPO
20 discount, you know, where the shares that are sold by the
21 foundation in the IPO are sold at a little bit of a
22 discounted price. So I think there might be a reluctance to
23 sell that much stock, 20 percent. But it is a possibility.

24 As I said, in WellChoice, most of the shares that were
25 sold were shares that were sold by the foundation and they

1 did about a 300 and something million dollar IPO. So it is a
2 possibility. There's also a possibility I think of doing an
3 IPO that's part Premera shares and part foundation shares.
4 And that might be the best place to end up. But again, it
5 really depends on the facts and circumstances as we get
6 closer.

7 Q Any thoughts as to what the impact would be on the value to
8 the foundations one way or another?

9 A In terms of an all secondary --

10 Q Yes.

11 A -- IPO? Well, again, I think the critical issue is do they
12 want to sell that much stock and what kind of valuation are
13 we talking about as we get closer to the IPO. And if there
14 is a big discount that the market is asking for and relative
15 to where, you know, other comparable companies are trading, I
16 think the foundation might not want to sell that much stock.
17 But if the market is well-received - or the offering is
18 well-received and it can be done at a smaller discount, then
19 I think they may want to sell more stock because of their
20 divestiture schedule and because of this 20 percent
21 limitation at the end of their first year, assuming that
22 stays in.

23 Q Which potentially would be more valuable to the foundation,
24 if it was done so to speak by just stock from the foundation
25 as opposed to a combination with Premera? Which one would be

1 more valuable to the foundation, value of the stock as it's
2 sold?

3 A My sense of things now - and obviously this can change based
4 on the facts - is that it probably makes sense for Premera to
5 sell a little bit of capital, bolster their RBC a little bit,
6 and for the foundation to sell some capital as well. I think
7 it's probably the best case. I mean I think Premera probably
8 does have some - some uses for the money. And even if you
9 just put it in bonds or just use it to bolster RBC, if they
10 sell 25 or 50 million of capital, that doesn't dilute the
11 foundation so much that it's that damaging. And then the
12 foundation can sell a slug. And then you basically have a
13 situation where they're getting some stock out. The
14 company's getting a little bit of stock and balance sheet
15 bolstering. That's good for the policy holders. So I think
16 it's probably a balance and a little bit from each is
17 probably the best way to come out.

18 Q If I could move over to voting trust. One of the issues that
19 was discussed would be the unlikely scenario where the Blue's
20 mark was lost to Premera. If that did happen - and
21 presumably it would be because of I believe you used the word
22 negative circumstances - in such a case, would the foundation
23 shareholders at that point, if they held a majority of the
24 shares presumably at that point, would they be in a position
25 then to want to exert some control over how Premera is run in

1 order to protect the value of their shares?

2 A I think they would want to have an input into that. And I
3 don't think they would run the company themselves.

4 Q Certainly.

5 A Yeah. Through the board. I mean I think at that point,
6 you're probably looking . . . Well, one scenario is that
7 you've gone through the minimum RBC for Blue Cross/Blue
8 Shield and they've taken away the license and you're
9 basically in a real capital-constrained position. If the
10 stock was public at that point, it would really take a
11 beating. And I think - so the foundation might want to
12 consider its options at that point. If they no longer had
13 the mark, you know, is it possible that an affiliation with
14 another nonbranded health insurer made sense to maximize the
15 value of the foundation's investment? Does it make sense to
16 maybe get someone in who's a turnaround specialist to help
17 turn the company around at that point? I mean I don't know
18 how deeply in distress the company would be. It's not as if
19 the foundation is going to go in and start running the
20 company themselves. They're just going to have a say in how
21 the company should get run. And they could still own a big
22 chunk of stock. They could own 50 percent of the stock or
23 60 percent. That's pretty typical, that a shareholder who
24 owns 60 percent of the stock can have a say in how it's
25 governed.

1 Q I meant to say what they could do to ensure that there were
2 competent board members and management to run Premera. Thank
3 you very much.

4 MS. deLEON: I have no questions.

5 MR. MITCHELL: I don't know what the protocol is,
6 but I did have --

7 JUDGE FINKLE: Well, we'll go back to the order -
8 the original order. Do you have any?

9 MS. deLEON: I have no further questions.

10 MR. MITCHELL: A couple.

11
12 RECROSS-EXAMINATION
13

14 BY MR. MITCHELL:

15 Q You mentioned the WellChoice precedent, Mr. Koplovitz. And
16 in that case, as I understand it, the converting company
17 issued a relatively small proportion of stock, the
18 foundations a much larger proportion. Is it not the case
19 that in WellChoice, the converting entity was already very
20 well capitalized?

21 A I did not work on that transaction so I don't know. Although
22 on the RBC chart that the company gave us, they don't seem to
23 be that much - Empire doesn't seem to be that much higher
24 than Premera on the chart. It's actually in our report.

25 Q Isn't it over 600 percent?

1 A I believe - I believe there's a page in our report, if you
2 don't mind if I could look.

3 Q Please.

4 A I'm just looking at page 26 of our report. And this is
5 actually a document that I think we got from the company.
6 And it actually shows Empire Blue Cross/Blue Shield at 427.

7 Q That was in 2001 though, was it not?

8 A But I believe that data would have been fairly close to when
9 they went public. I mean again, I don't have the exact
10 figures in front of me.

11 Q In any case, would you not agree, Mr. Koplovitz, that the
12 time to decide the appropriate shares between the foundations
13 and Premera as well as the likely receptivity of the market
14 to a particular given size of the stock is when the IPO is
15 actually approaching?

16 A I would agree with that.

17 MR. MITCHELL: Nothing further.

18 MS. McCULLOUGH: No.

19 MS. deLEON: Nothing.

20 JUDGE FINKLE: Thank you. Please step down.

21 We'll see you at 9:00.

22 (Proceedings adjourned at 5:00 p.m.)

23

24

25

STATE OF WASHINGTON)
) ss.
COUNTY OF GRAYS HARBOR)

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